



House of Commons
Treasury Committee

**The administration of
tax credits:
Government Response
to the Committee's
Sixth Report of Session
2005–06**

**First Special Report of Session
2006–07**

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The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury and its associated public bodies.

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Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) from Session 1997–98 onwards are available on the Internet at www.parliament.uk/parliamentary_committees/treasury_committee

Committee staff

The current staff of the Committee are Colin Lee (Clerk), Fiona McLean (Second Clerk and Clerk of the Sub-Committee), Adam Wales and Aruni Muthumala (Committee Specialists), Lis McCracken (Committee Assistant), Michelle Edney (Secretary), Tes Stranger (Senior Office Clerk) and Laura Humble (Media Officer).

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First Special Report

The Treasury Committee published its Sixth Report of Session 2005–06, *The Administration of Tax Credits*, on 23 May 2006, as House of Commons Paper No. 811. The Report arose from an inquiry by the Sub-Committee. The Government response to this Report was received on 8 November 2006, and is appended below.

Appendix: Government response

Part A: Current issues

Overpayments of tax credits

1. Recent research published by the Economic and Social Research Council Research Centre for Analysis of Social Exclusion indicates that the month-to-month incomes of low-to middle-income working families with children are considerably more volatile than might have been expected. We welcome the fact that such research has been undertaken: it offers valuable data to those involved in designing tax credits policy. We are pleased to see the Government funding such a study, which seems to us to offer precisely the sort of information the Government needs to enable it to provide State assistance in a way which fits with the income patterns of those targeted. We recommend that the Government direct additional resources to funding research likely to inform the formulation of tax credits policy. (Paragraph 21)

The Government agrees with the Committee that the research published by the Economic Centre was valuable. The Government always said it will review the system in the light of experience and drew heavily on that work when it designed the package of measures it announced at the Pre Budget report to make tax credits work better for families and increased the disregard from £2,500 to £25,000. The Government agrees that it is important that its policies are evidence-based. HMRC has an external research programme to support evidence-based tax policy making and its evaluation of the impact of implemented policies, as well as supporting its day to day business. This includes a number of reports on tax credits going forward and historically.

2. We are particularly struck by the Research Centre's findings that such families tend to budget over a month or less, rather than over the whole of a tax year, and that, in nearly a third of cases studies, income was more variable after including tax credits than before doing so. These findings suggest that the tax credits scheme, which is designed to deliver the correct amount of state assistance over the year as a whole, rather than over any shorter period, could be aligned more closely to the financial needs of such families. End-of-year adjustments in tax credit entitlement may come too late for such families, and any demand for reimbursement is felt very keenly by them. We suggest that there is evidence that determining awards over shorter time periods would reflect the needs of lower income families more accurately than annual awards. (Paragraph 22)

The Government appreciates that families tend to budget over short periods but would not draw the conclusion that determining awards over shorter time periods would reflect the needs of lower income families better. It believes that setting an award annually and recovering any overpayment gradually over the whole year with automatic limits on recovery of excess amounts for families gives the necessary certainty while being fair to the taxpayer and giving the flexibility to respond to families' changing circumstances.

Moving towards determining awards on shorter time periods would increase the frequency of means testing which families find intrusive. It also makes it easier to manipulate circumstances to increase artificially tax credits awards. (See response to recommendation 26)

3. From the above figures it follows that about 30% of all overpayments are due to delays in reporting changes in families' personal circumstances, such as family breakdown or the establishment of new partnerships, or a child going to school or leaving home. However it is clear from the oral evidence from HMRC officials that the focus is on the other three categories of overpayment. We believe that enough attention has not been paid to the problems caused by families' changing circumstances and the difficulty of adjusting tax credits to reflect these. We therefore recommend that more research is undertaken into this, especially in view of impending changes in reporting requirements. (Paragraph 27)

The Government agrees that changing circumstances are an important cause of overpayments but is cautious about putting a percentage on the figure for the reasons outlined in paragraph 25 of the Committee's report. However, because it is difficult to put reliable percentages to particular causes does not mean that not enough attention is being paid to the issue. The announcements at the Pre-Budget report were a package of measures designed to ensure the tax credits system strikes the right balance between providing a stable award and maintaining the ability to respond to changes. One of the themes of that package was that claimants will have clear responsibilities to report changes promptly, and will be helped to keep their records up to date, including through more proactive contact by HMRC. This included extending the categories where it is mandatory to report a change, and the shortening of the deadline to do this which will reduce the risk of overpayments because claimants' awards are based on out of date information.

4. The factors cited by the Paymaster General and her officials as contributing to the problem of overpayments do not appear to us to give a comprehensive account of the reasons which overpayments have arisen. While we are not in a position to draw up our own comprehensive list of factors resulting in overpayments, it is obvious to us that the Paymaster General's account makes no reference to causes of overpayments which have arisen as a consequence of the Department's own processes—for example, official error and IT system error. Rather, the Paymaster General has referred only to those causes of overpayments which can be attributed to claimant error or omission, or to the design of the tax credits regime, or a combination of both. (Paragraph 28)

5. It seems self-evident to us that HMRC cannot take steps to improve the way in which it administers tax credits without first identifying, and developing a detailed understanding of, the factors which cause overpayments and the extent to which each individual factor has contributed to the overall overpayments problem. We

recommend that, as a matter of priority, the Government provide a detailed breakdown of as much of this information as is currently available. (Paragraph 29)

6. It is clear that official error has been a cause of overpayments in a significant number of cases. The Paymaster General has said that no complete analysis exists of official error causing or contributing to overpayments. This is a significant gap in HMRC's understanding of the reasons why overpayments arise. If HMRC is to succeed in improving the administration of the tax credits regime, the first thing it needs to understand is what is going wrong within its own processes, before it looks to problems elsewhere. We recommend that the Government undertake a complete analysis of the incidence of official error and the extent to which it causes or contributes to overpayments, and that it publishes that analysis. If it is unable to carry out such an analysis, it should explain why. (Paragraphs 31 and 35)

7. Just as HMRC appears to have attempted no complete analysis of the contribution made by official error to overpayments, so we have seen nothing from the Department attempting to assess the contribution made by IT system error. Again, it seems obvious to us that HMRC must acquire a thorough understanding of the problems which have arisen if it is to succeed in improving the administration of the tax credits regime. We recommend that the Government undertake a complete analysis of the incidence of IT system error and the extent to which it causes or contributes to overpayments, and that it publishes that analysis. (Paragraph 49)

The Government notes the Committee's conclusions. It agrees that it is important for HMRC to understand its own processes. Many of the overpayments resulting from official and IT error arose from the well documented early problems with the IT system. These have been analysed and the system is now stable and delivering flexible, responsive tax credits to 6 million families. Accuracy in processing and calculating awards rose from 78.6 per cent in 2003–04 to 96.5 per cent in 2004–05 and 97.7 per cent in 2005–06. HMRC has followed a policy of writing overpayments off, where it is reasonable to believe that the claimant thought their award was correct.

A great deal of information has already been published on the causes of overpayments and amounts written off, and more since the Committee has reported. For example, the main causes of overpayments are given in the Paymaster General's Statement to Parliament of 5th December (Column 55WS–57WS), The Comptroller & Auditor General's reports on the Inland Revenue and HMRC accounts for 2003–04, 2004–05, and 2005–6, and HMRC reports on Child and Working Tax Credits Error and Fraud Statistics 2003–04 and Tackling Error and Fraud in the Child and Working Tax Credits.

However, it can be difficult to establish from tax credit records whether the claimant or HMRC is responsible for a particular error, for example, whether information was incorrectly reported or incorrectly recorded.

8. It is clear that the IT system which EDS delivered for the running of new tax credits was unsatisfactory in a number of respects. We have grave concerns about the wisdom of an agreement which then makes the payment of compensation to the affected government department by the provider of the unsatisfactory service contingent on that provider winning other contracts with government. Our concern is not that we

believe the contingent payments will influence future decisions by government departments to award contracts, but that it will be impossible to be sure that they have not. The agreement has the appearance of impropriety, if not the fact. (Paragraph 50)

The Government notes the Committee's concerns about how the structure of the settlement may appear. It agrees with the Committee that no impropriety has taken place and believes an examination of the facts shows that any such impression is unfounded. The Public Accounts Committee has rightly encouraged departments to take commercial approaches to secure best value for money. HMRC believes that is what it has done with the EDS settlement. It is the largest ever settlement with an IT supplier that HMRC and its advisers are aware of in the UK.

The payments remaining to be made by EDS will not prejudice the Government's future procurement decisions. Each such decision will be made on its merits, with due regard to the legal and commercial requirements, to achieve the best value for money. Procurement law requires that all bids be given equal consideration and that government departments obtain the best value for money.

HMRC has had detailed discussions with the Office of Government Commerce in order to ensure that, through its work and contacts, other departments are aware that this settlement must have no influence over other government contracts.

9. We also draw the attention of the House to the confidentiality agreement which formed part of this settlement, and which so constrained the Chairman of HMRC in his ability to respond to our questioning. We are extremely concerned that HMRC appears to be claiming to have effectively 'contracted out' of its obligation to be publicly accountable for its administration and expenditure, by virtue of having entered a private contract. The existence of such a confidentiality requirement also makes it impossible for the House to assess what happened in this particular case, and to seek to draw broader lessons from it about the problematic area of government IT contracts. We recommend that the Government ensure that this particular settlement does not indicate the start of a trend on the part of public bodies towards agreeing such confidentiality requirements. We further recommend that the procurement, design, project management and delivery of the tax credits process and systems be independently examined by the National Audit Office, regardless of this agreement. (Paragraph 51)

The Government notes the Committee's conclusion. The Government feels that HMRC has struck an appropriate balance that maximised value for the public purse by, on the one hand, preserving an acceptable degree of commercial confidentiality for EDS and, on the other hand, allowing full accountability to appropriate scrutinising bodies.

Had it been necessary to pursue EDS in the courts, HMRC would have faced a significant diversion of senior staff time as well as significant litigation costs, and the matter would not have been resolved for several more years.

While complete transparency is desirable, the confidentiality arrangement in the settlement agreement with EDS did not in practice impair public accountability. The agreement allowed full disclosure of all terms of the agreement to all appropriate public bodies.

Confidentiality provisions are common in commercial settlements which forestall litigation of large sums. However, HMRC insisted that this allowed it to disclose details to all bodies necessary to satisfy its public scrutiny and accountability requirements.

We note the Committee's recommendation with regard to the NAO.

Recovery of overpayments

10. We endorse the Ombudsman's recommendation that HMRC should not seek to recover either an excess payment made in the current year, or an overpayment from the previous year, until it has come to a decision, based on all the relevant facts, as to whether or not the excess amount paid should be recovered in accordance with COP 26. We are pleased that the Government appears to have accepted this recommendation. However, we are concerned by the apparent lack of urgency in seeking to implement the 'pause' before recovery of an overpayment, and seek an explanation from the Government for the reasons for this delay. (Paragraph 58)

11. We understand that implementing such a pause may well be technically difficult, and that it is only one of a number of improvements which the regime requires. However, it is crucial, in the interests of natural justice, that excess payments and overpayments are not automatically recovered without due regard first being given to the principles set out in COP 26. It is unfortunate that implementation of this essential improvement appears to have been sidelined by the package of reforms announced in PBR 2005. We recommend that the Government reassess the priority which it appears to have assigned to this improvement. (Paragraph 59)

The Government announced to the House on 7th June 2006 that HMRC entirely support the Ombudsman's recommendation in principle to give taxpayers 30 days notice before commencing recovery. Sir David Varney explained to the Committee that it was important to ensure that it was introduced in a way which did not jeopardise the stability of the tax credit computer system. There is no doubt that this will be technically challenging and the department has been working to scope out the issues involved. Implementation of the Pre Budget Report package as quickly as possible is a priority for the computer system to help reduce overpayments by around a third. HMRC also have to continue to deliver other improvements to the IT system many of which are in response to concerns raised by the Ombudsman and others. These include automatic suspension of overpayments, a new award notice and improvements to the renewals notice which gives the claimant a comprehensive history of their award. The Government has accepted the case in principle for a period of notice before recovery of an overpayment begins and HMRC will continue to try and develop opportunities to implement.

12. We recommend that, as a minimum, HMRC ensure it has written guidelines in place to assist staff in determining whether it was reasonable for a particular claimant to have thought his or her payments were right, in all the circumstances. The reasonableness test cannot be applied as a stringent objective test, but must take account of a claimant's circumstances, the clarity of the award notices issued to him or her and, where appropriate, any limitations on the claimant's capacity to understand an award notice. No doubt these requirements could place a heavy investigative burden on HMRC in certain cases. However, it seems to us that this is the price HMRC must

pay if it is to continue applying a reasonableness test, rather than a test along the lines of the social security test, where overpayment of a benefit can be recovered only where the claimant has misrepresented or failed to disclose a material fact. (Paragraph 70)

The Government agrees with the Committee that there should be clarity on what constitutes whether it was reasonable for a particular claimant to have thought his or her payments were right. Working with the voluntary and community sector, HMRC has therefore rewritten Code of Practice 26, What happens if we have paid you too much tax credit?, which sets out how it will deal with overpayments of tax credit.

The list of details that claimants are expected to have checked on their award notice is set out in the one sheet guidance that is sent with every award notice as well as the Code of Practice 26. HMRC expects claimants to have checked certain easily identifiable details on their award notice - for example, the number of children in the family or the family's income. HMRC would also expect people to tell them if they received any payments that did not match what was shown on the award notices during the period that the overpayment arose. In contrast HMRC would check themselves that their calculations were correct based on the information provided.

The Code of Practice confirms that though claimants are expected to check their personal details on their award notice there may be exceptional circumstances why a claimant could not. This could be because of a bereavement of a close relative or the claimant being in hospital. In such circumstances claimants are advised to tell the Tax Credits Office why they could not check their award notice or the payments they received. The Tax Credits Office will then look at the claimant's reasons why they were unable to check their award notice or payments and have the discretion to write off an overpayment even where the award notice details were incorrect or there was an additional payment into their bank account.

13. The relevant statute law would appear to directly contradict HMRC's Deputy Chairman's statement that, in the benefits regime "there is not a statutory right of appeal in relation to recovering overpayments generated by official error". Such a right of appeal appears to be precisely what section 12 of the Social Security Act 1998 is intended to provide. (Paragraph 77)

14. We are bemused by the account of the law given by HMRC's Deputy Chairman, which appears to directly contradict the relevant statutory provisions. We invite the Government to clarify what it understands to be the rights of people receiving social security benefits to an independent appeal of a decision to recover an overpayment. (Paragraph 77)

HMRC's Deputy Chairman was correct in his statement to the Treasury Committee that there is no appeal right where Department of Work and Pensions (DWP) ask for repayment of overpayments caused by official error.

The DWP provide a right of appeal against a decision to recover an overpayment which arose because of an error or omission *by the claimant or other person*. The social security legislation referred to in the Treasury Committee report confirms that there is a right of appeal where the Secretary of State (under section 71 Social Security Administration Act

1992) decides to recover an overpayment of benefit from a claimant or any other person who, fraudulently or otherwise, misrepresented or failed to disclose any material fact.

This is different from an overpayment caused solely by official error. DWP's policy is to ask for repayment where an overpayment is caused by official error where it is reasonable to expect the claimant to have been aware they were being overpaid. DWP have no statutory test or right of appeal for recovering overpayments caused solely by *official error*.

Moreover, both departments have a discretion as to whether to recover and both have a published policy which governs the exercise of its discretion.

Neither department provides an appeal right in respect of its discretionary decision. For example, a tribunal considering an appeal against a decision under s71 cannot consider whether the Secretary State should exercise his discretion to waive recovery.

15. We strongly support the calls from the voluntary sector and the Ombudsman for the introduction of a right of appeal to an independent tribunal against a decision by HMRC on a disputed overpayment. We recommend that the Government introduce whatever legislation is necessary to enable claimants to exercise such a right of appeal, as a matter of priority. If the Government intends to delay still further on this matter, we recommend that it explain its reluctance to allow tax credits claimants access to justice, and that it report on the practical implications of introducing an independent right of appeal. (Paragraph 80)

16. We note that HMRC is considering, with the HMRC Adjudicator, if the Adjudicator might be able to provide a fast-track, independent review of decisions on disputed overpayments. Although it is unclear from the Paymaster General's statement, we assume that introducing such a regime would require the Adjudicator's remit to be extended. (Paragraph 81)

17. Even if the Adjudicator's remit were to be extended, we do not accept that such a review procedure is an adequate substitute for a right of appeal to an independent tribunal. We will continue to follow this issue closely, and will examine with interest any detailed proposals which may be forthcoming from HMRC and the Adjudicator. (Paragraph 82)

The Government notes the Committee's conclusion. Claimants have a right of appeal if they believe their award is incorrect. End of year adjustments are part of a responsive system of support and most overpayments are fully recoverable. Current policy is for overpayments to be written off where there has been a mistake by HMRC *and* it was not reasonable for the claimant to have noticed the error.

Claimants can complain if they disagree with the decision or matters are not resolved to their satisfaction. Ultimately HMRC's handling of their case can be reviewed by the Adjudicator, a person independent of HMRC and through the Parliamentary Ombudsman.

HMRC are exploring with the Adjudicator's office the feasibility of introducing a fast-track process that would provide claimants with the option of an independent review of a decision made by the Department to seek recovery of an overpayment caused by official

error. Such an approach would not require legislation and would not require her remit to be extended.

Fraud, error and organised crime

18. We are concerned that it is now over two years since the end of the 2003-04 tax year, and yet HMRC is still to establish final levels of claimant error and fraud in the tax credits regime for that year. Given that the final figure is likely to be significantly higher than the interim figure of 3.4%, we question why the Department has not moved more quickly to establish a complete picture of patterns of claimant error and fraud in 2003-04, to put it in a stronger position to address the problem in more recent tax years. We recommend that the Government put appropriate procedures in place to ensure that similar work for tax years 2004-05 onwards is completed more promptly. (Paragraph 86)

HMRC published on 11th July 2006 statistics on error and fraud in 2003–4 estimated from its random enquiry programme. The Government anticipates that 2004–5 will follow a similar timetable. The random enquiry timetable is designed to ensure HMRC measures error and fraud for a representative sample of awards that have been finalised. In most cases awards are not finalised until the September following the award year and for some not until the following January. HMRC then under the legislation has a year to take up an enquiry. Thus for 2004–5 this means enquires cannot be started until at least September 2005 (some January 2006) and can be taken up to January 2007. Enquiries then take time to be worked through and a robust estimate produced.

These figures showed that the level of error and fraud in tax credits is lower than under Working Families Tax Credit and is also comparable with figures relating to social security benefits when the Government first collected data on a systematic basis. "Tackling Error and Fraud in Child and Working Tax Credits" sets out the comprehensive action HMRC has taken to address error and fraud in tax credits. This showed that during 2005–06 HMRC prevented three quarters of all attempted organised fraud that has been identified, protecting £409 million in payments.

19. On the basis of the information available to us at the present time, and given that a criminal investigation is underway, it would be inappropriate for us to comment on whether HMRC could have done more to prevent fraudulent claims from entering the tax credits system. At this stage, we are also not in a position to establish whether HMRC ought to have identified the problem at an earlier stage, or to have realised the vulnerability of the e-portal sooner. (Paragraph 102)

The Government believes that they responded promptly to the threats posed to the tax credits system, maintaining the balance between accessibility of the scheme to claimants and safeguarding against the risk of error and fraud. The evidence available to HMRC is summarised in part II of the Comptroller and Auditor General's Standard Report, on HMRC's 2005–6 accounts. During 2005, the Department detected an increase in the number of organised attacks on the tax credits system, predominantly via the internet. The Department continued to monitor the situation closely. In November, new information came to light about what appeared to be a specific and unprecedented attack on the system. In the light of the virulent and highly organised nature of the attack, the Department

judged the balance of risks had changed significantly, and a decision was taken to suspend the internet service from 2 December 2005.

20. We note the Paymaster General's assurances that the Government has no current plans to reduce the numbers of staff working in tax credits compliance. In its response to this report, we recommend that the Government make a clear statement about its future plans for compliance, both in terms of levels of staffing and processes, to indicate how developed those plans are and to set out a timescale for any decisions it intends to take in this area. (Paragraph 103)

HMRC has an active strategy in place to tackle tax credits fraud and has realised significant achievements in combating fraud since the introduction of tax credits. Building on results already achieved by the teams engaged in claimant compliance activities, HMRC is increasing the number of tax credit compliance staff by a further 200. This part of HMRC is also undergoing an internal restructuring to increase the efficiency and effectiveness of its compliance work so that there are around 10 large tax credit and child benefit compliance offices in strategic locations, each with a small number of geographically linked sub-offices.

HMRC also published its plans for tackling error and fraud on 11th July 2006.

Part B: Looking forward

Package of reforms announced in PBR

21. As we said in our Report on the 2005 Pre-Budget Report, we welcome the fact that the Government is seeking to improve the operation of the tax credits regime by introducing a package of reforms. However, we remain concerned that the Government has said it is unable to provide a breakdown of the costs or yields of each individual measure within the package. We feel greater attention needs to be paid to trying to disaggregate the different costs of the present system, especially those associated with reporting changes of circumstances. We have received evidence which suggests that the costings for the package were based on "incomplete and uncertain" information, the use of which required HMRC to exercise "a substantial degree of judgement" and to make "a range of assumptions of a policy-related nature". Given this, we question how the Government can be confident of its estimates of the overall costs of the package. (Paragraph 118)

The Government has always been more confident about the overall cost of the PBR package which is based on the total level of overpayments. The estimates were based on data from the first year of the system and provisional information from the second year.

As the Treasury explained in giving evidence to the Committee in preparation for their report on the 2005 Pre Budget Report (Ev 84), the Exchequer effect of the changes to the tax credit system depend crucially on the source of overpayments. At that stage there was only limited information available on the sources of overpayments as HMRC only had complete data on 2003-04 overpayments, which were not representative of the system in steady state. This difficulty in accessing good quality data in the past made costing the individual elements of the package difficult.

However following publication of the 2004–05 overpayment statistics in May 2006, HMRC now has two years of overpayment statistics to inform this costing. And crucially, unlike in 2003–04, awards in 2004–05 were based on the previous years income making them much more representative of future years awards. In addition the first stage of the finalisation process for 2005–06 was completed in August 2006, adding to this body of knowledge. This additional information has not led the Government to change the costing of the disregard—or the package as a whole—however it has allowed it to feel more confident in the costing of the individual elements of the package.

There are still some uncertainties surrounding the costing. In particular it remains the case while the overall cost of the package is not affected by the order with which the changes are modelled, these interactions mean that the costs of the individual elements of the package are affected by the assumed order.

Subject to these uncertainties the costing of the £25,000 disregard over the period 2006–07 to 2010–11 is provided below:

	Exchequer effect (£m)				
	2006-07	2007-08	2008-09	2009-10	2010-11
Income disregard of £25k	-50	-100	-150	-250	-300

22. The Government expects the package of reforms to be broadly revenue neutral, despite the fact that the decision to increase the disregard threshold from £2,500 to £25,000 will be costly. It follows that some or all of the remaining components of the package must be expected to reduce expenditure or yield revenue. (Paragraph 119)

23. We infer from this that the Government expects the reduction in expenditure or yield in revenue from the introduction of tougher reporting requirements for claimants to be significant. Claimants who do not report changes in circumstances to HMRC, or who negligently provide information, are liable to significant fines. We recommend that the Government clarify whether, as a result of the implementation of the PBR package of reforms, it expects to receive increased revenue from fines payable by tax credits claimants and, if so, by how much it expects revenue to increase. We seek an assurance from the Government that it will enforce the penalty regime proportionately, taking into account the circumstances in which an individual claimant finds him- or herself. We recommend that the Government undertake and publish a review of the operation of the system of fines after the first 18 months of operation. (Paragraph 120)

The Government can assure the Committee it is not expecting to fund the Pre Budget Report package from any fines payable by tax credit claimants. It has never suggested that this might be the case. It publishes information annually on penalties to Parliament as part of its reporting obligations under Section 40 of the Tax Credits Act 2002. Penalties are only a last resort and HMRC will enforce the regime proportionately.

The Pre Budget Report package is fully costed and funded. Some elements of the package have a cost to the Exchequer (for example, the disregard) and others have a yield (for

example, the reduction in reporting time). This yield comes from measures designed to reduce the amount of money paid out to claimants that later turns out to be an overpayment. In effect, these measures prevent money going out that we would then have to recover later.

24. The existence of the disregard threshold means that those claimants whose income increases will receive the benefit of both their increased income and their unadjusted tax credits entitlement for the remainder of the tax year, before experiencing a drop in income in the following tax year. One effect of the ten-fold increase in the disregard will be that this drop in income may well represent a significant sum of money (depending on the amount of the increase in income). We recommend that HMRC make clear to all claimants who report an increase in income of between £2,500 and £25,000 that, if their other circumstances remain relatively unchanged, their tax credits entitlement in the following tax year is likely to drop, possibly by a significant amount. We do not consider this amounts to HMRC presuming to offer "financial advice" to claimants, as officials suggested: the purpose should be to make clear to claimants that they should not plan their financial arrangements on the basis that they will continue to receive their current level of tax credits payments. (Paragraph 126)

The Government agrees with this recommendation. The revised award notices sent to a claimant following them reporting an increase in income also give provisional payments for the next year.

25. We have received evidence that the increase in the threshold will benefit only those claimants who see an increase in income in the current year as compared with the previous year, because the income disregard threshold is applied on the basis of comparison with the previous year's income. Claimants who, in the current tax year, see their income start and finish lower than the previous tax year but nonetheless rise within the year will receive no benefit from the increased threshold. We invite the Government to comment on whether it has considered ways of addressing this anomaly. (Paragraph 127)

The Government does not agree that it is an anomaly that the disregard works one way. In the circumstances outlined the claimant would have their award on the previous year's income. As the current year's income is lower then the claimant may be entitled to a higher level of tax credits immediately.

26. The increase in the disregard of income to £25,000 creates a greater incentive for claimants to seek to substantially increase their tax credit entitlement by arranging for their annual income to fluctuate in alternate years. We recommend that the Government ensure it has adequate procedures in place to detect such abuse of the regime. (Paragraph 129)

The Government notes the Committee's concerns. The Government believes that with entitlement determined by annual income, rather than over short period as with previous systems of support, it is harder in practice to manipulate the income in the way which has been outlined. HMRC remains vigilant to identifying and tackling abuse and Tax Credit legislation contains anti-avoidance provisions to prevent the manipulation of income.

As part of its compliance effort, HMRC looks at a large number of factors to determine which claims pose the greatest risk. One of these factors is unusual or anomalous fluctuations in income. The increase in the income disregard will not stop this factor being used by HMRC to identify and intervene in order to correct or stop inappropriate claims.

Improving HMRC's service to claimants

27. The Government expects the ten-fold increase in the disregard threshold to reduce the current level of overpayments by one-third. This suggests that the remaining two-thirds of overpayments arise as a result of changes in claimants' circumstances other than increases in income. Consequently, over the next few years, although the tax credits regime may see a decrease in the numbers of overpayments being made, levels of overpayments are likely to continue to be high. At the same time, claimants' problems may well become increasingly complex, as their case history within the regime lengthens. (Paragraph 132)

The Government expects, when the Pre Budget Report package is fully implemented, end of year adjustments leading to overpayments to decrease by a third. It expects that both the number and level of overpayments to reduce as different elements of the package bite. For example, the change in reporting requirements are likely to influence both the number and average amount of overpayments as people will have less time with their awards based on out of date information. National statistics already show a fall in the average amount of overpayments— a fall of just under a fifth between 2003–4 and 2004–5.

28. The contribution which HMRC's departmental culture may have made to the difficulties experienced by tax credits claimants is difficult to measure. We consider that the transfer from DWP to the Inland Revenue of administrative responsibility for delivering State assistance did require a culture shift on the part of the latter Department, in order to take account of the different objectives of funding Government expenditure through tax collection, on the one hand, and delivering State assistance to those in need, on the other. On the basis of the evidence we have taken and our visit to the TCO in Preston, it seems to us that HMRC has started to make the cultural transition required, although it still has some way to go. However, we are not convinced that the Paymaster General and the Department fully realise the extent to which HMRC needs to re-focus its administrative structures for tax credits around the needs of claimants. (Paragraph 135)

HMRC appreciates the importance of high quality taxpayer service for all its taxpayers. Tax credits staff are committed to ensuring families receive their correct entitlement, helping and assisting claimants in, sometimes, difficult circumstances.

Moving family support into the tax system has had great advantages. Because the system is based on annual income it has meant that it is possible to design a flexible system which responds to changing circumstances and is not based on continual intrusive means testing. It has improved work incentives and reduced stigma with take up higher than any previous support for families.

HMRC recognises it has much more to do to focus its administrative structures for tax credits around the needs of claimants. HMRC is implementing a step change in culture

placing taxpayer service as the focus of all improvement activities. The primary vehicle for this change is known as PaceSetter and the Tax Credits Office is one of the early innovators in this wider departmental initiative.

HMRC is also working on a strategy to deliver tax credits in the future with the claimants at the heart of their activities. This includes aiming for greater success at first point of contact and moving away from a uniform service so that delivery is tailored to recognise that different taxpayers will require different levels of support. Tax Credits and Child Benefit have a shared claimant base that currently have to contact HMRC twice to claim and update their details. HMRC are aiming for clearer communication with taxpayers - such that their interactions are more helpful, and their forms and guidance are easier to understand. At the same time it will need to make its systems more efficient, cost effective and secure. This is very much a long-term aim which HMRC plans to work towards.

29. As we have already discussed, the Paymaster General's public account of the causes of overpayments referred only to those attributable to claimant error or omission or to the design of the tax credits regime. Her statement made no reference to causes of overpayments which have arisen as a consequence of the Department's own processes, such as official error and IT system error. We consider it would be much more helpful if the Department were to focus on the quality of the service it provides to claimants, rather than seeking to attribute the majority of problems with the tax credits regime to error or omission on the part of claimants. We recommend that the Government examines closely what contribution its own processes have made to the difficulties experienced with the tax credits regime. (Paragraph 138)

The main causes of overpayments are given in the Paymaster General's Statement to Parliament of 5th December (Column 55WS-57WS). End of year adjustments do arise because of delays in claimants reporting changes of circumstances. That is why the package of measures announced at the Pre Budget Report included greater responsibilities on claimants to report changes of circumstances as they occur and claimants will be helped to keep their records up to date with more proactive contact by HMRC. HMRC fully recognises that it needs to focus on the quality of service that it provides to its claimants and to examine its own processes. It is taking a long-term look on how it delivers tax credits which is described in the response to Recommendation 28.

30. Under the Government's efficiency savings programme, HMRC is required to make a 13% cut in staffing by April 2008. We note evidence from HMRC officials that these efficiency savings are not expected to affect the TCO until 2007-08. We appreciate that staff numbers are not a measure of effectiveness. We nevertheless recommend that, prior to implementing any cuts in TCO staffing, the Government consider carefully whether such cuts will have a detrimental effect on the administration of tax credits. We intend to keep a watching brief on how the Government's efficiency savings programme affects the administration of tax credits, as part of our broader interest in the Government's efficiency savings agenda. (Paragraph 145)

HMRC is confident that it will achieve its Spending Review 2004 overall workforce reduction target of 12,500 net full-time equivalent posts by 31 March 2008, whilst maintaining the delivery of a quality service to taxpayers. Some parts of the business may change rapidly, but the process as a whole of achieving the workforce reductions target will

be incremental and the Department will ring-fence key areas of work, such as tax credits, for the time being to ensure service delivery is not compromised. The quality of service that HMRC gives to tax credits claimants continues to improve. For example, for the first 6 months of this financial year HMRC had answered 99.7% of callers on the day against a target of 95%. It answered 345,000 more Tax Credit calls and the percentage of calls answered in 20 seconds has risen to 80.5%. HMRC are continuing to turn the vast majority of new disputed overpayments round within 4 weeks of receipt.

31. We commend HMRC for recently introducing improved award notices, in consultation with the voluntary sector, and on the helpful two-page checklist which now accompanies award notices. (Paragraph 151)

32. We recommend that the Government work towards developing a more proportionate and flexible system for the issuing of award notices, in which notices are not issued for trivial changes in circumstance (for example, a change in phone number) and in which, at the time of reporting a change in circumstance, a claimant can choose not to receive a consequential notice. (Paragraph 152)

Learning from the experience of the first two years of tax credits, HMRC has taken a number of steps to ensure its communications are more claimant friendly and forms are easy to complete. Building on these important steps HMRC is reviewing its communications, including through extensive consultation with those who represent tax credit claimants. The review has identified a number of improvements to be made and work has begun to implement these changes. The Government agrees with the Committee that the new award notice (which has been revised following consultation with the voluntary and community sector) has been valuable. Getting the award notice right is a key element of HMRC's strategy to improve claimant understanding of tax credits and will mean official and claimant error will be picked up on earlier. Better information for claimants is being supported by improvements to HMRC procedures. Since the introduction of new tax credits, HMRC has reduced the numbers of unnecessary award notices issued, for example award notices are no longer issued following notification of a change in address.

33. We are concerned by evidence that claimants have experienced difficulties in obtaining form TC647, which sets out details of how their award was calculated. We recommend that the Government ensure that all claimants are made aware of, and regularly reminded of, their ability to request details of the calculation of their award entitlement. (Paragraph 153)

The new award notice now contains similar information to the old form TC 647, so that this means that all claimants now get details of how their award notice is constructed, without having to request a separate form.

34. We are disappointed that the Government's timetable for introducing an annual comprehensive 'playback' statement for an individual claimant, setting out HMRC's records of his or her income and circumstances for the previous year, appears to have slipped. We consider that the introduction of such a measure would be valuable, and we will continue to monitor progress on its implementation. (Paragraph 154)

The Government agrees with the Committee that the "playback" statement will be valuable. It does not think it is fair to say that the timetable to introduce it has slipped. As the Committee has recognised, award notices from April 2006 have provided a much clearer summary of claimants' awards, what changes have been taken into account and how their payments have been calculated. Taxpayers will see these improvements *each time* they receive a revised award and a helpful two-page checklist now accompanies award notices. HMRC is now building on those improvements for the *annual* "playback" statement for the November 2006 computer release.

35. The tax credits helpline is the frontline for claimants making direct contact with HMRC. As such, it is critical that the advisers staffing it are thoroughly trained and properly equipped to perform their roles. We recommend that the Government ensure that all advisers staffing the general helpline are thoroughly trained, and that all helpline advisers receive the same high level of training and supervision. (Paragraph 160)

The Government agrees with this recommendation and this is what happens now. The general tax credits helpline and the helpline to support the voluntary sector do different things and serve different customer bases. These specialist helplines deal with the more complex cases or the minority of cases which have gone wrong, while the general helpline have to deal with much higher volumes of more routine enquiries. The general tax credits helpline operates to the same high level as the helpline to support the voluntary sector and MPs.

36. We are concerned by the Paymaster General's update to us on progress on her May 2005 undertaking to ensure that helpline operators can track the progress of individual cases in the system, and seek clarification from the Government on this point. We can confirm that this is indeed an issue that we would like to see the Government taking forward as a matter of priority. We consider it is absolutely fundamental to the successful administration of tax credits that HMRC staff dealing with an individual claimant can see all relevant information pertaining to that claimant 'at a glance'. We recommend accordingly. (Paragraph 161)

The Government agrees that it would be useful for HMRC to be able to see a summary position of a claimant's award. HMRC is planning to introduce improved summary screens by October 2007 which will enable staff to gain a better overview of the whole of the award's history.

37. We commend HMRC for the positive step it has taken towards improving the way it deals with complex cases, by setting up a specialist team for the express purpose of handling complex cases. We recommend that the Government give further consideration to ways in which it can implement a much more extensive caseworker-based approach for difficult or complex cases, so that a claimant would have a single point of contact to guide him or her through the system. (Paragraph 166)

The Government notes the recommendation and agrees that it is important that for a complex case a claimant should have a single point of contact. TCO passes cases over to the complex case team which require an extensive caseworker approach.

In responding to letters of complaint, the TCO provides the claimant with a direct dial telephone number to enable them to speak to the caseworker handling their complaint. It aims to acknowledge such letters within 2 days of receipt.

38. We recommend that the Government publish data on the time taken to handle disputed overpayments. In addition to setting out average times, this data should also set out the numbers of disputed overpayments received in 2003-04, 2004-05 and 2005-06 and break down the time taken to process all of those disputed overpayments. We recommend that the Government also publishes data on what proportion of disputed overpayments it is writing off, and the basis on which they are being written off. (Paragraph 169)

The Government has published much of the information already requested by the Committee in the answer to Parliamentary questions. These can be summarised in the following table:

	Overpayments disputed	Overpayments written off as result of the dispute
2004-5 ¹	215,000	10,300
2005-6	367,500	160,500

The amounts written off are on the basis of the criteria set out in Code of Practice 26.

HMRC has substantially reduced its turnaround times for disputed overpayments. It is now answering the vast majority of new disputes in less than 4 weeks and it aims to maintain this level of service to its claimants. Unfortunately some cases cannot be resolved within 4 weeks and HMRC is actively seeking ways to resolve these cases as quickly as possible.

39. We are pleased that the Government has finally disclosed the criteria it used in applying the 'streamlined' procedure, which was in place from Spring 2005 until at least 1 February 2006, and probably more recently than that. It is frustrating that the Government has chosen to disclose the criteria so late in our inquiry process, more than two months after we requested it, and well beyond the point at which we can reasonably seek comment from witnesses on the criteria. We would welcome an explanation of the relationship of the criteria chosen to the likelihood of error, as the criteria appear, on the face of it, to be arbitrary. Witnesses believed that this procedure had resulted in a significantly higher proportion of write-offs than had been the case under previous criteria. (Paragraph 178)

HMRC, in deciding on the appropriate criteria to be used in the streamlined process, bore in mind that whether an overpayment is written off is dependent on the claimant meeting a two-limb test:

- a mistake on the part of HMRC;
- grounds for reasonable belief on the part of the claimant that the award was right.

The matrix was based on practical experience and modelling of the cases. It balanced the risk of the claimant not qualifying for official error had a full investigation been undertaken

¹ End of year adjustments only start after the end of the tax year so there were no disputed overpayments in 2003-4. Renewal packs were first sent out from April 2004 and data was first recorded from May 2004.

against the amount of the overpayment outstanding. There was a bigger risk that the claimant would ultimately be found not to qualify for official error relief if a full investigation had taken place where there were fewer award notices. So, in the latter cases, HMRC was only prepared to write off a lesser sum. Where there was a greater number of award notices it was more likely that official error would be established if there was a full investigation and so writing of higher sums was justified.

40. We are concerned that claimants appear to have been treated differently, depending on whether their disputed overpayment was considered before or after the introduction of the streamlined procedure. Given that the streamlined procedure is no longer being applied, it is unclear if HMRC has returned to using the criteria in place prior to the introduction of the streamlined procedure, or if a further set of criteria is now being applied. We recommend that the Government ensure that those claimants whose disputed overpayments were not written off, prior to the introduction of the streamlined procedure, are given the opportunity to have their disputed overpayments reconsidered under the criteria applied in the streamlined procedure. We also recommend that the Government clarify what criteria it is now applying in considering disputed overpayments, given that the streamlined procedure is now in place. (Paragraph 179)

The legitimate expectation of those claimants, who had their dispute considered prior to the introduction of the streamlined procedures, was that their case would be considered fully under the policy that was applicable at the time they applied. That policy was set out in Code of Practice 26.

The Government does not believe it is justified for claimants whose cases have been fully examined under the criteria set out in the Code of Practice to be given the option to have their case re-examined under the streamlined-procedures. Claimants whose cases were examined prior to the introduction of the streamlined procedures can be assured that HMRC's decision took full account of the claimant's reasons why they did not think they should pay back an overpayment, and their case history.

It would be inequitable that where a claimant has had their case fully considered, and the overpayment found to be properly repayable, they should have the chance to see if it would be remitted.

HMRC is applying the procedures as set out in Code of Practice 26 for new cases.

41. We recommend that the Government ensure that appropriate invitations have been issued to the Northern Ireland voluntary sector to be represented on the Tax Credits Consultation Group. (Paragraph 181)

The Government agrees with the Committee. There has been an open invitation for at least the last year to three voluntary sector bodies in Northern Ireland to be part of the Tax Credit Consultation Group. To date, no one has been able to attend. HMRC is in contact with these bodies to explore whether it might be helpful for them to send a single representative to act on behalf of them all, in the same way that the Scottish voluntary sector bodies are already represented on the group by Citizen's Advice, Scotland.

42. Our overwhelming impression from considering how HMRC might improve its service to claimants is the extent to which the administration of the tax credits regime has been based around individual functions or tasks, rather than centred around the needs of claimants. This approach has had implications for TCO staff, who have been cut off in task-based silos, with no oversight of the whole tax credits process. Crucially, it has also had implications for claimants, who have been moved between these functional 'silos' with no one person having oversight of, or taking responsibility for, their case. If the design of the tax credits IT system did not institute this approach, it certainly perpetuated it. (Paragraph 182)

43. It is crucial that HMRC focus on what more it can do to institute a claimant-centred approach to administering tax credits. HMRC's purpose in administering tax credits should be to provide a service to claimants. The quality of service provided to claimants by HMRC will be crucial to the success of the tax credits regime, and the critical measure of service will be what HMRC does with a claimant's report of a change in circumstance once it has received it. As Citizens Advice pointed out, one consequence of the fact that the tax credits regime gives claimants more money than its predecessor regimes is that, if administrative errors are made, claimants will incur more debt. HMRC has a responsibility to claimants to ensure that its administrative processes are geared around delivering reliable and predictable State assistance to those on low incomes. (Paragraph 183)

44. We are encouraged that, on the basis of the evidence we have received and our visit to the TCO in Preston, the TCO's administrative processes seem to have begun to move in the right direction, towards a model in which staff are able to take greater oversight of the process. (Paragraph 184)

45. We commend HMRC for the moves it has made to deal better with complex cases and to improve the award notice, and for the introduction of the checklist which now accompanies the award notice. In addition to the specific recommendations set out above, we recommend that the Government ensure that the TCO continues to move away from a purely task-based approach to administering the tax credits regime, towards a much more claimant-centred approach. (Paragraph 185)

HMRC is firmly focused on delivering a quality service for all its taxpayers, and the Committee has acknowledged the progress already made in TCO towards a model which gives staff a greater oversight of more of the tax credit process and the efforts made to deal with complex cases. TCO calls the model giving greater oversight 'clustering' and it brings together a number of tasks which represent a key part of the process—for example all the tasks which might need to be undertaken before an award can go into payment are 'clustered' in a 'Pre-Award' Cluster. This enables staff working in the cluster to have a much wider view of that part of the process and, therefore, to give a much better taxpayer service.

Availability of information about tax credits regime as a whole

46. We consider that greater priority should be given to ensuring that HMRC collects and analyses such data as will enable the Government to improve the design of the tax credits regime. If the tax credits regime is to prove a success for all claimants, it is

critical that the Government requires HMRC to take a thorough, planned approach to collecting data which will inform fine-tuning of the tax credits regime and appropriate deployment of departmental resources. We recommend accordingly. (Paragraph 193)

47. However, it is not enough for the Government to ensure that HMRC collects appropriate and sufficient statistical data and information. We recommend that the Government also ensure that such statistical data and information is published, in a readily accessible form. (Paragraph 194)

The Government agrees with the Committee that the collection of data and analysis is necessary to fine-tune the tax credits regime. HMRC gives a high degree of priority to this and has analysts working on Tax Credits information in the Knowledge Analysis and Intelligence Directorate. It publishes a great deal of information on their website, reports and accounts as well as ad-hoc requests through parliamentary questions.

48. We draw to the attention of the House the regrettable lack of priority which has been assigned to requests from this Committee for information central to our inquiry. We expect the Minister to ensure that the Department responds to requests from this Committee promptly. (Paragraph 196)

The Government regrets any delay in responding to the Committee's enquiries and was concerned that the Committee had the latest possible evidence to assist their deliberations. The Minister therefore made a statement before she gave evidence on 1 February. The reason for the delay in responding to the Committee's request for supplementary evidence was because as officials explained to the Committee that HMRC needed to decide carefully whether the criteria used for the streamlined procedures could be disclosed publicly. It would not have been appropriate for HMRC to publish details of these streamlined procedures whilst they were still in use or there was any risk that they would need to be used again. This is because the procedures involved a risk-based approach that meant we would not check low-risk claims in detail. Now HMRC has ceased to use the procedures this logic no longer applies. Other changes to the procedures for dealing with disputed overpayments such as the introduction of suspension to recovery means that HMRC would not envisage using the same matrix in future.

Design of the tax credits regime

49. We heard some compelling evidence from groups advising claimants that the childcare element of the working tax credit is unduly complex and a probable cause of overpayments. (Paragraph 202)

50. Despite this, HMRC has not undertaken any modelling to assess the implications of removing the childcare element from the working tax credit and delivering the financial support it offers to claimants by some other mechanism. The Paymaster General made it clear that she saw no point in undertaking such modelling, and suggested that it was difficult to understand how claimants could end up with overpayments as a result of claiming too much for childcare costs. From the evidence we have heard, claimants may well find the requirements associated with claiming the childcare element to be both complex and burdensome. It also seems to us that, because the amounts of money provided under the childcare element are quite generous, the

potential for large overpayments is significant. We recommend that the Government examine whether the requirements associated with the childcare element are capable of being simplified. We also recommend that the Government seriously explore alternative mechanisms for delivering the financial support offered by the childcare element. If the Government decides not to pursue any of these alternatives, it should provide detailed reasons for this decision. (Paragraph 203)

The Government notes the Committee's conclusions. The childcare element of the Working Tax Credit is helping to make childcare more affordable for low- and moderate-income families. 374,000 families are receiving assistance with their childcare costs through the childcare element, by an average of £50 per week. As a demand-side mechanism, it maximises the choice for parents, minimises income assessments (since the calculation of the childcare element is done through the general assessment of tax credit entitlements), and avoids the additional burden that providers would face if they had to administer the system. However, the Government is always willing to consider alternatives which simplify the system, meet the needs of parents and are affordable.

51. A number of our witnesses also suggested that the administrative burden imposed on HMRC by the tax credits regime could be alleviated, and the tax credits regime simplified, by removing the family element of child tax credit and adding it to child benefit. The Government considers that such a modification would be "more expensive", but was unable to comment in any detail, because HMRC has not modelled the implications of such a modification. We recommend that the Government examine in greater detail more efficient ways of delivering support, including the possibility of removing the family element from the child tax credit and adding it to child benefit. (Paragraph 210)

The Government continues to examine ways of improving the efficiency of the delivery of financial support, but has no plans to move the family element of the Child Tax Credit to Child Benefit.

52. We have not sought, in this inquiry, to ask whether the model of tax credits regime which the Government has adopted is the right model. Nor have we examined the pros and cons of the range of possible models. We note the Chancellor of the Exchequer's indication that he is keeping an open mind on the possibility of returning to a regime of fixed awards, in which entitlement is based on the previous year's income. (Paragraph 214)

The tax credit system strikes a balance between providing the flexibility to respond to changes, and maintaining certainty of income for families. The measures set out in the Pre Budget Report will mean that there will be greater certainty for claimants, particularly for families who see a rise in income, but the flexibility to respond to falls in income and changes in circumstances will be maintained.

In the Pre Budget Report, the Government said it will continue to listen to the case for a fixed system, but believed on balance that it is preferable to maintain the current system.

HM Treasury

8 November 2006