OFFICIAL REPORT
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Public Audit and Post-legislative Scrutiny Committee

Thursday 11 January 2018

Session 5

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Pàrlamaid na h-Alba

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PUBLIC AUDIT AND POST-LEGISLATIVE SCRUTINY COMMITTEE
1st Meeting 2018, Session 5

CONVENER

*Jenny Marra (North East Scotland) (Lab)

DEPUTY CONVENER

*Liam Kerr (North East Scotland) (Con)

COMMITTEE MEMBERS

*Colin Beattie (Midlothian North and Musselburgh) (SNP)
*Bill Bowman (North East Scotland) (Con)
*Willie Coffey (Kilmarnock and Irvine Valley) (SNP)
*Iain Gray (East Lothian) (Lab)
*Alex Neil (Airdrie and Shotts) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Stephen Boyle (Audit Scotland)
Caroline Gardner (Auditor General for Scotland)
Sir Amyas Morse (National Audit Office)
Michael Oliphant (Audit Scotland)
Mark Taylor (Audit Scotland)
John Thorpe (National Audit Office)

CLERK TO THE COMMITTEE

Terry Shevlin

LOCATION

The Sir Alexander Fleming Room (CR2)

Scottish Parliament

Public Audit and Post-legislative Scrutiny Committee

Thursday 11 January 2018

[The Convener opened the meeting at 09:02]

Interests

The Convener (Jenny Marra): Good morning and welcome to the first meeting in 2018 of the Public Audit and Post-legislative Scrutiny Committee. I ask everyone in the public gallery to switch their electronic devices off or to silent so that they do not affect the committee's work. I welcome Iain Gray to the committee—I should say "welcome back", as he previously convened the committee. Iain Gray replaces Monica Lennon as a Labour Party member of the committee. I am sure that members will join me in thanking Monica Lennon for her contribution to the work of the committee. My special thanks go to Jackie Baillie for her role as acting convener while I was on maternity leave.

Agenda item 1 is a declaration of interests. I ask Iain Gray to declare any relevant interests.

Iain Gray (East Lothian) (Lab): I have nothing to declare.

Decision on Taking Business in Private

09:03

The Convener: Agenda item 2 is a decision on taking business in private. Does the committee agree to take items 5, 6 and 7 in private?

Members *indicated agreement.*

Section 22 Report

"The 2016/17 audit of the Scottish Government's Non-Domestic Rating Account"

09:03

The Convener: Under agenda item 3, we will take evidence from Audit Scotland on a section 22 report. I welcome Caroline Gardner, the Auditor General for Scotland; Stephen Boyle, assistant director at Audit Scotland; and Michael Oliphant, senior audit manager at Audit Scotland.

I invite Caroline Gardner to make an opening statement.

Caroline Gardner (Auditor General for Scotland): Welcome back, convener. I wish all members of the committee a happy new year.

My report today is on the 2016-17 audit of the Scottish Government's non-domestic rating account, under section 22 of the Public Finance and Accountability (Scotland) Act 2000. Stephen Boyle is the appointed auditor responsible for the audit, and his independent opinion on the account is unqualified. That means that he is satisfied that the account properly presents the receipts and payments for the year ending 31 March 2017 and the balances held at that date.

The purpose of my report is to support the Parliament's scrutiny and understanding of non-domestic rates at a time when Scotland's public finances are becoming increasingly complex with the arrival of new financial powers. In particular, I will draw the committee's attention to issues that are highlighted by the audit relating, first, to the financial position and, secondly, to the transparency of the account.

The first point to make is that the operation of the non-domestic rating account is complex. In simple terms, the account is prepared annually to show the amount of non-domestic rates collected by councils and pooled by the Scottish Government and the amounts that are distributed back to councils by the Government as part of the annual local government financial settlement.

The balance on the account will always be in surplus or deficit at the end of the year due to forecasting and timing differences. At the end of 2016-17, the account showed a deficit balance of £297 million, which means that, in recent years, the Government has paid out more to councils in non-domestic rates than councils have collected. This is the third consecutive year in which the account has had a deficit balance. In February last year, the Government signalled its intention to bring the account back into balance over a number of years, but, as my report highlights, there is not yet a formal plan to do so.

The second area to emphasise concerns the transparency of non-domestic rates, which form a significant component of the Government's annual budget and its funding to local government. I have recommended that the Government should increase the consistency and transparency of financial information on non-domestic rates as part of its commitment to longer-term financial planning. That includes publishing details of how the amount that is distributed to councils each year is calculated and how the Government expects the non-domestic rating account balance to change over time. That will help the Parliament to better understand how non-domestic rates contribute to the wider Scottish budget and its long-term sustainability as well as the impact on local government. The establishment of the Scottish Fiscal Commission provides an opportunity to increase transparency in the area.

We are happy to answer the committee's questions.

The Convener: Thank you very much. Colin Beattie has the first question.

Colin Beattie (Midlothian North and Musselburgh) (SNP): Given that the audit of the account is unqualified, will you explain why there is a section 22 report?

Caroline Gardner: Absolutely. As the committee knows, section 22 reports are the route that I have for bringing to the attention of the committee and the Parliament matters that arise from the audit of the various accounts that I am responsible for auditing each year. The reports are sometimes used when there is a qualification on the accounts, but, more often, they are brought because there is an issue of public interest or of strategic importance that I think merits the committee's attention. In this case, as I said in my opening remarks, given that we have had a deficit balance in the past three years, which is now approaching £300 million, and the fact that the transparency of non-domestic rates can be improved in the context of the Scottish Government's budget becoming more complex with the new financial powers, I decided that it was appropriate to report on the account for the first time in my term of office.

Colin Beattie: Has the Government accepted your recommendations?

Caroline Gardner: The Government has made a general commitment to increase the overall transparency of its financial reporting and budget information, and it has accepted the recommendations of the budget process review group, which were published last June. The issue fits neatly within that. There are clearly choices about the way in which that is done, but the principle has been accepted.

Colin Beattie: The main issue is the deficit and how it is to be dealt with. You said that part of the issue is to do with timing. How much of the deficit relates to timing?

Caroline Gardner: I will ask Stephen Boyle to give you some information on that, but initially it might be worth referring the committee to exhibit 2 on page 8 of my report, which shows the surplus or deficit in each of the past six years and the way in which those have combined to form a cumulative surplus or deficit. The exhibit shows that, over the past three years, we have had a deficit balance building up and that we have had deficits in each of the past four years, so it is not just a year-on-year movement.

Stephen Boyle (Audit Scotland): Much of the deficit relates to timing. From exhibit 2, you can see that there are fluctuations from one year to the next. Exhibit 1 sets out the movement between 2015-16 and 2016-17. The account is complex, as it is subject to post-year adjustments and the effect of any resultant allowances or disallowances from the previous year. Although a timing element contributes to the scale of the £297 million deficit, that is not the only factor. As we say, there are other elements, the main one of which is the resultant policy choice that the Government makes about the scale of the distributable amount. In addition, as Mr Beattie rightly said, there are timing differences, which means that the account is never likely to be exactly in balance in any one year.

Colin Beattie: Is there any way of factoring out those timing differences in order to get a real figure?

Stephen Boyle: We think that that is unlikely, given the scale of the account, which £2.8 billion or so goes through. Because it is likely that any appeals process will straddle more than one financial year, it is reasonable to say that timing differences will be an inherent factor in the preparation and management of the account.

Colin Beattie: Given the timing factors and so on, would you say that the current deficit is reasonable? Could we anticipate its being at about that level? I see that it fluctuates quite a bit from year to year.

Stephen Boyle: As we say in the report, we would expect fluctuations from one year to the next. We also note in the report that 2016-17 was the fourth year in a row in which there was a deficit in the account, which has been growing. We thought that that was an important factor to capture in the annual audit report and the Auditor General's section 22 report.

Colin Beattie: Put simplistically, the councils make a projection of what moneys they will receive and, on the basis of that projection, the Government decides what to pay the councils. Therefore, I presume that there must be some negotiations about the deficit. Do those negotiations take place with individual councils or with the Convention of Scottish Local Authorities?

Michael Oliphant (Audit Scotland): The distributable amount that the Scottish Government will set is part of the Scottish budget, so it is part of the overall local government funding settlement. When fluctuations occur during the year, the Scottish Government will adjust the general revenue grant component of that. The overall funding element of the local government funding settlement is guaranteed for that year, so the issue will form part of the negotiations on the overall funding settlement for that year.

Colin Beattie: That would be the subject of negotiation with COSLA.

Michael Oliphant: That would form part of the normal process of negotiations on the draft budget.

Colin Beattie: Do we know how that is broken down in terms of who receives what?

Caroline Gardner: I will take us back a step. The decision on the overall distributable amount that the Scottish Government puts into the budget is a policy decision for the Scottish Government and is subject to the normal budget process; it is not the subject of a negotiation with COSLA or with individual councils. However, there is an element of negotiation on the overall local government settlement and, during the budget process, the estimate of the distributable amount might be subject to change. Members may recall that, during last year's budget negotiation process, the Scottish Government revisited its assumptions about non-domestic rates receipts and increased the distributable amount for 2017-18 by £60 million. That had the effect of delaying the point at which the account was likely to come back into balance.

That was an appropriate approach to take, but it was not transparent to the Parliament or more widely because of the way in which the information was broken down between different budget documents and different financial reporting documents. Transparency is one of the reasons for our report.

Colin Beattie: I presume that the figure of £60 million was based on projections of how much non-domestic rates income was going to be received.

Caroline Gardner: One of the underlying reasons for our report is that the basis for the estimates of the distributable amount is not clear. I think that Stephen Boyle would like to add to that.

Stephen Boyle: As we mention in the report, the additional £60 million was subject to further provisional collectable amounts that were provided by local authorities, so there is an element of connection there.

Colin Beattie: Is it the case that the only way in which the account can be put back into balance is by reducing the allocation to councils for non-domestic rates? Is that the only mechanism for doing that?

Caroline Gardner: That could also be done by reducing the amount of non-domestic rates collected because of increases in the tax base or increases in the tax poundage. Due to the way in which the Scottish budget is becoming more complex—it has more moving parts—there is more room for transparency around the Government's assumptions of that in each individual budget year and, as part of the Government's commitment to longer-term financial planning, over time.

09:15

Iain Gray: You have already addressed this question, Auditor General, but perhaps you could say a little more about why you decided to wait until now to report on the deficit. The table on page 8 of your report shows that the biggest deficit was in 2014-15 and that there was a similarly significant deficit in the following year. Why did you wait?

Caroline Gardner: As Stephen Boyle said, we would expect there always to be either a surplus or a deficit in the account in any one year, which you can see in the second line from the bottom in exhibit 2 and, in more detail, in the appendix to the report. That is partly about timing differences and partly about forecasting differences.

The fact that there is a deficit balance is, in itself, not a matter of concern to me. The bigger concern is the extent to which the deficit is continuing to grow and the fact that it is quite hard for that to be made transparent to the Parliament in the budget process at a time when there are other elements of uncertainty and volatility because of the devolution of income tax and other new taxation powers.

Iain Gray: The budget process happens annually. If I understood your answer to Mr Beattie's previous question, you are saying that, as part of the budget process, the Government can vary its estimate and, in essence, borrow from local government's future budgets to balance the current year's budget. Should that not be reported on annually so that we understand exactly how the budget has been arrived at? The Government can change the estimate in order to balance the budget—is that a fair way of describing what you have just said?

Caroline Gardner: That is one of the possibilities. The challenge at the moment is that it is not clear what is driving changes in the Government's assumptions about the amounts that will be raised and its decisions about the amount that will be distributed to local government in each budget process. What has actually happened becomes clear over time in the account, but there is a risk, which we see now, that that can lead to an accumulation of a deficit balance that is increasingly significant. The recommendations that I make in the report about publishing the underlying assumptions and a longer-term look ahead at what will happen in each year and to the cumulative balance would be the answer to your question, rather than the individual decisions being made annually.

Liam Kerr (North East Scotland) (Con): Can you help me out with something? Is the deficit an actual financial deficit in the sense of its being a minus figure in a bank account somewhere that is accruing interest and that is being serviced by a different budget?

Caroline Gardner: The non-domestic rating account does not reflect a fund; it reflects an account that aims to show the amounts that are collected and paid out by the Government over time. Stephen Boyle can talk you through the process in more detail.

Stephen Boyle: The requirement to prepare the non-domestic rating account dates back to the Local Government Finance Act 1992. Its purpose is to demonstrate that the non-domestic rates amounts that have been collected have been paid out. The account is referred to as an extract account of the Scottish consolidated fund, and the flow of funds through the consolidated fund is part of the overall arrangements.

As the Auditor General said, there is no deficit sitting in a fund per se; the non-domestic rating account exists to illustrate that the non-domestic rates that have been collected have been distributed. As we mentioned in earlier answers, the account will always balance to zero, and there have been fluctuations over many years into surplus and into deficit.

Liam Kerr: That makes sense up to a point. A cash sum is paid out before receipts have come in, hence there is a minus figure, but where does that money come from?

Michael Oliphant: As we have noted in previous years, the distributable amount that is set and that has resulted in the deficit arising has, in effect, been a result of the Government paying more to councils than has been received. The amount is set as part of the overall Scottish budget, so the money comes from the Scottish consolidated fund and, if the money that comes back in does not quite match the distributable amount because of lower-than-expected collections, the Scottish Government balances that out across its overall budget.

Liam Kerr: The Government intends to get rid of the deficit over time. What will be the practical impact of that on local authority funding and on local authorities' ability to deliver services?

Stephen Boyle: You are right in saying that the Government has signalled its intention to bring the account back into balance. Ultimately, the overall funding that is allocated to local government in general is a policy decision. If that intention is followed through and the non-domestic rating account returns to balance, the distributable amount will, over time, be lower than the collectable amount that is recorded for the purposes of the account.

In some of the key messages in the report, we touch on the relativity of non-domestic rates compared to the overall funding arrangements for local government, which capture the revenue support grant and other elements. We note that non-domestic rates income accounts for 29 per cent of the total allocation to local government from the Scottish Government.

Liam Kerr: We are using a lot of terms that people will find challenging—I find them challenging. Is it fair to say that, in order to get rid of the deficit, there might be a cut in the amount that is distributed to local authorities?

Stephen Boyle: Ultimately, it depends. That would not necessarily be connected to the reduction in the deficit in the non-domestic rating account. It remains a policy decision for the Scottish Government how much it chooses to allocate to local authorities. However, it has signalled its intention to bring the account back into balance and, if doing so means that the distributable amount that relates to the account is lower, the Government might choose to offset that reduction through other funding mechanisms.

Liam Kerr: You make an important point, Mr Boyle. The Scottish Government has chosen to bring the account back into balance. I will say this as a statement but I ask you to take it as a question. There is, I presume, no legal or formal accounting requirement for the Government to bring the account into balance—it is a choice that is being made. If I am right about that, I presume that there is nothing to prevent the Scottish Government from running a deficit or a surplus in the future.

Stephen Boyle: That is correct. The legislation that set up the account does not require it to operate in surplus or in deficit. The only obligation is that an account be prepared and that it demonstrate that the amounts that have been collected have been distributed. There is nothing to prevent any Scottish Government from operating the account in deficit.

Liam Kerr: I am grateful.

Bill Bowman (North East Scotland) (Con): Good morning. When the cash that goes out is more than the cash that comes in, somebody somewhere has to fund that. Therefore, there is a funding requirement in that situation. We can talk about funds, parts of funds and an account, but there is a cash deficit.

Michael Oliphant: I think that your question relates to the transactions and the money that goes into and out of the Scottish consolidated fund. The local authorities pay money in during the year as rates are collected, and they receive money through the distributable amount from the Scottish Government and general revenue funding. Those amounts are all netted off, so the transactions are just net payments between Governments and councils.

Bill Bowman: But the Scottish Government is still out of pocket until that is resolved.

Michael Oliphant: There will be a deficit that will be recovered from future—

Bill Bowman: But the Scottish Government is out of pocket. There is a cash deficit.

Michael Oliphant: That deficit will require to be recovered from future years.

Bill Bowman: The term “signalled” is a very good one. It means nothing, really, does it? There is no legal obligation on anyone to do something if they have just “signalled” that they are going to do something.

You say that there is always a deficit or a surplus. That is acceptable if the amounts are small, but those amounts build up. Does the hole in the accounts affect the amount that the finance secretary can distribute this year? Does he take that into account when he decides how much he has available to give to local authorities and how much he must raise in tax?

Caroline Gardner: That affects the overall amount that is available in the Scottish Government budget in the year to come and, depending on the policy decisions that the Government makes about the amount that it intends to distribute to local government as part of the settlement, it affects the amount that is available to local government. At both levels, it is clearly not possible to keep distributing more in non-domestic rates than is collected. As you say, that has happened—

Bill Bowman: If local authorities had paid this sum, Derek Mackay would have £300 million more in his budget to distribute this year.

Caroline Gardner: It not so much to do with local government not paying the sum; it is more to do with what the situation would be if the Scottish Government had paid out less than the distributable amount in each of the past four years.

Bill Bowman: Whichever way you look at it, if there was a surplus, Derek Mackay would have £300 million more in his budget this year.

Caroline Gardner: Yes.

Bill Bowman: Liam Kerr asked about accounting. You gave a clean audit opinion, which means that you have no doubt that the sum is recoverable. The Government has only “signalled” that it is going to get it, but you are happy that the sum will be collected.

Stephen Boyle: We are required every year, as auditors, to consider the going-concern principle, as well as whether there is a deficit in an account. It is for management to determine whether an organisation can continue in any respect. Our obligations as auditors require us to make a judgment on that; we would consult auditing standards and the “Government Financial Reporting Manual”, which sets out the criteria, were that judgment to be in doubt. We considered the position and concluded our audit opinion and decided that there was nothing further to be done and no need to make any reference to the situation in the audit opinion. Nevertheless, we think that it is an important matter that ought to be brought to the committee’s attention, which is why we captured it in the annual audit report and the section 22 report.

Bill Bowman: So, you relied on the signalling.

Stephen Boyle: Ultimately, its being an account that is required to demonstrate the amounts that are collected and receivable—an extract account—and the presence of the consolidated fund reassure us sufficiently that the situation will not evolve into an issue with regard to the going-concern principle, for the purposes of the account.

Bill Bowman: I find it interesting that you need to bring the issue to us in a special report but would not mention the issue in your own report. However, that is your judgment.

The other thing that we can take from the discussion is that the Government can decide to either collect the sum or write it off in the future.

Stephen Boyle: I would not say that the Government could decide to write the sum off, but it could certainly decide to collect it. However, for as long as there is a deficit, there is—

Bill Bowman: I think that you said that the Government could adjust the amounts that it could distribute.

Stephen Boyle: The deficit will either remain or it will be recovered, depending on the extent of the distributable amount or the amounts that local authorities decide to collect. There is no provision for writing off a deficit balance on the account.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): I do not see that there is a particularly big issue here: it is just about financial transactions that are affected mainly by timing changes. In one year the local authorities might be the beneficiary and in another it might be the Scottish Government. Until the point at which the account is completely balanced, there will be winners and losers each year, but at the end of the process, when the account is balanced, there are no winners or losers, because the money that is sent to the Scottish Government is fully returned to local authorities. That is how I see it.

How does the reconciliation process work? Does the Scottish Government return to local authorities amounts that they have overpaid? Does that happen per local authority, or is a compound amount distributed to councils? Are there local authorities that lose out in that process, or does each local authority get back what it overpaid?

Caroline Gardner: I will pick up your first point and then ask Stephen Boyle and Michael Oliphant to follow up on the second point.

I entirely agree that if we were seeing a surplus in one year and a deficit in another, there would not be an issue. However, as table 2 shows, in recent years there have been deficits one year after another, and there was a rapidly increasing deficit until the end of 2016-17. That leaves £300 million that will need to be recovered at some point through the account, in the context of the overall Scottish budget. That is why I decided to bring the report to the committee. Stephen Boyle or Michael Oliphant will pick up on the reconciliation process.

09:30

Michael Oliphant: I will pick that up. As the question outlined, the issue is about timing differences. At the start of the year, a council estimates what it will collect, and during the course of the year it pays that amount to the Scottish Government. It is only when we get to the end of the year that we know by how much the figure was out.

There are two scenarios in which reconciliation is required: when a council has collected more than it expected—it then pays the additional amount into the NDR pool or NDR account—and when a council has received less than it expected, in which case the Scottish Government reimburses the amount. The key point is that, where there are fluctuations, the Scottish Government alters the level of the general revenue grant so that each individual council gets what was intended as part of the local government financial settlement, and that smooths out any fluctuations for councils.

Willie Coffey: That is kind of what I meant: at the end of the process, when the account is in balance, there are no winners and losers. I imagine that that is the way that it should turn out, ultimately.

Caroline Gardner: When the account is in balance, that is the case. The process of getting it back into balance means that that £300 million is not available for spending as it would have been if the account had remained closer to balance over the past three years.

The Convener: Auditor General, the Scottish Government has said that it intends to bring the account into balance by 2020. How achievable is that?

Caroline Gardner: It is difficult to answer that question in the absence of the other information that I have recommended should be available. Towards the end of my report, in paragraph 28, I set out a range of things that would improve the available information and would allow us and, more important, Parliament to understand the underlying assumptions and the ways in which they affect the budget as a whole and local government. Until we have that information, it is difficult to see what the impact will be of bringing the account back into balance, which is why “signalling” the intention is not sufficient. We need a plan, and the underlying information that makes that plan testable by Parliament, as part of the budget process.

The Convener: Does the plan need to incorporate that and will the information that you are looking for improve on the unpredictability of the account as it stands?

Caroline Gardner: As we have said in response to previous questions, there will always be differences that are due, straightforwardly, to timing, and there will be differences because a forecast is only ever a forecast and will never be right. However, it should be possible for the forecasts to be better understood and better tested and, therefore, to be clearer over time. That would also allow Parliament to understand the policy decisions that are being made and proposed by the Government about the amount that it intends to distribute in the local government settlement.

During last year's budget process, as we touched on earlier, the Government's estimate of the distributable amount was increased by £60 million. That was based on information that was available to the Government but not to Parliament about where differences were arising. We do not yet know what the outcome was, but in a budget that has more moving parts, volatility and uncertainty, it is important that there is more clarity about how that particular strand of revenue is being managed over the long term, in line with the Government's wider commitment to more transparency and longer-term financial planning.

The Convener: Thank you. That is useful. For the committee's information, are there any other areas of policy in which there is a similar lack of information or transparency and with which you could draw parallels?

Caroline Gardner: It is difficult to talk about individual streams, although the committee will be aware that the overall thrust of the budget process review group's report was to try to present the overall picture, rather than individual streams of revenue and expenditure, and how the strands interact with one another. It is difficult to overstate how much more complex the Scottish Government's budget is now than it was even a couple of years ago. That complexity will increase further up to 2020, at least, so having the big picture is increasingly important.

The Convener: Thank you very much for your evidence. I suspend the meeting for a couple of minutes to change witnesses.

09:34

Meeting suspended.

09:36

On resuming—

"The administration of the Scottish Rate of Income Tax 2016-17"

The Convener: Agenda item 4 is evidence taking on the administration of the Scottish rate of income tax in 2016-17. I welcome to the committee Caroline Gardner, Auditor General for Scotland, and Mark Taylor, assistant director, Audit Scotland. I also welcome Sir Amyas Morse, Comptroller and Auditor General, and John Thorpe, executive leader, National Audit Office.

I invite opening statements from Caroline Gardner, followed by Sir Amyas.

Caroline Gardner: Thank you, convener. I will keep it brief.

As we have been discussing, income tax is a major part of the package of new financial powers that are being implemented as a result of the 2012 and 2016 Scotland acts. Taken together, those powers are substantially changing Scotland's public finances.

The reports that are before the committee today relate to the Scottish rate of income tax in 2016-17, following its introduction in April 2016. In considering the reports, it is important to bear in mind the respective responsibilities of those involved.

Her Majesty's Revenue and Customs administers and collects Scottish income tax as part of the United Kingdom's overall income tax system, and is responsible for developing and maintaining the systems that are needed to implement decisions that are taken by the Scottish Parliament on rates and bands. The Scottish Government funds that by reimbursing the costs of administering and collecting Scottish income tax. The Scottish Government also seeks assurances that the system collects the correct amount of tax and that this is brought to account.

The National Audit Office audits HMRC's accounts, and the Comptroller and Auditor General is responsible for reporting to the Scottish Parliament on HMRC's administration of Scottish income tax. I provide the committee with additional assurance on the NAO's audit work, in line with a recommendation from the then Public Audit Committee in 2014. This is the third year of that arrangement.

In summary, my report confirms that I am satisfied that the NAO's audit approach was sufficient and robust, and covered the key audit risks. I am also satisfied that the findings and conclusions in the C and AG's report are reasonably based.

The Scottish Parliament now has the power to set the income tax rates and bands for non-savings, non-dividend income for Scottish taxpayers, which means that the Scottish rate of income tax arrangements were only in place for a single year. Nonetheless, the underlying administration arrangements that operated in 2016-17, particularly the accurate identification of Scottish taxpayers, remain fundamental to the effective operation of the new, wider Scottish income tax powers.

I will hand over to the C and AG to introduce his report.

Sir Amyas Morse (National Audit Office): Thank you very much, convener, for inviting me. My colleague and I are delighted to be here.

The Auditor General for Scotland has set out HMRC's responsibilities for the collection and administration of Scottish income tax, and she has spoken about our respective responsibilities, so I will not repeat those comments. However, it is probably worth saying that my role is just the same as hers, but in relation to the UK Parliament.

Under the legislation, we are required to report on the adequacy of the rules and procedures that HMRC has put in place in consequence of the Scottish rate provisions, for the purpose of ensuring that the proper assessment and collection is undertaken of income tax that is charged at rates that are determined under those provisions.

We are obliged to comment on whether those rules and procedures are being complied with; the correctness of the sums brought to account by HMRC that relate to income tax and which are attributable to the Scottish rate resolution; and the accuracy and fairness of the amounts that are reimbursed to HMRC as administrative expenses that have been incurred as a result of the charging of the Scottish rate of income tax.

The report is for 2016-17, and it is fair to say that there is probably quite a lot more to come next year. The report is on the first year of HMRC's administration of the Scottish rate, which, as you know, went live in April 2016. The key findings are set out in paragraphs 9 to 19 of the report and my conclusion on page 10. In previous years, we have highlighted the importance of HMRC keeping its information on the Scottish taxpayer population up to date, and HMRC has now taken steps to improve the validation of who are, and who should be, Scottish taxpayers. However, it is still the case that the identification of the tax base is fundamental to the effective operation of Scottish income tax, and it is an area that we will continue to examine and push on in future years. Although things have improved, we are not saying that the destination has been reached, and I am quite sure that members will want to ask questions about change of address and so forth.

On the correctness of the sums brought to account, the committee will appreciate that the final outturn for 2016-17 will not be reported until HMRC presents its annual report and accounts in July 2018. I will report to the committee in greater detail in my next report, once I have had the opportunity to examine the sums brought to account.

I thank the Auditor General and Audit Scotland. We have worked very well together, as we always do, but I am very grateful for all the co-operation and close working as we have done our work.

The Convener: Thank you for those helpful opening statements. Alex Neil will ask the first question.

Alex Neil (Airdrie and Shotts) (SNP): I have two questions. This is the first year of operation of the Scottish rate, and in the recent Scottish budget, the Cabinet Secretary for Finance and the Constitution put forward proposals for an increase in the number of income tax bands, which will result in a number of people in the lower-income groups having their income tax bill reduced. However, it will also result in a number of people in higher-income groups having their income tax bill increased.

Under the current arrangements, what scope is there for people—particularly those in higher-income groups—to dodge the higher rates of income tax in Scotland?

Sir Amyas Morse: I am not being evasive when I say that I think you could also have a very useful discussion about that with HMRC, which is on point for it. The more difference there is between rates of tax in Scotland and rates of tax in England, the more potential inducement there is to engage in avoidance.

I go back to what I said: it is crucial to identify Scottish taxpayers. We think that the systems environment and the systems arrangements in HMRC—which I will ask my colleague John Thorpe to say more about, because he certainly knows more about them than I do—should be perfectly adequate to enable it to compute the different rates of tax accurately if it has the right data about who the taxpayers are. As you know, there is a continuing question about change of address and so forth.

The view is that the differential in tax rates creates pressure on the system, but it is not axiomatic that that pressure cannot be managed.

John Thorpe (National Audit Office): I will develop that point. The national insurance and PAYE service system, which was introduced in HMRC in 2010, consolidated tax records on individuals. That was a big step forward. Each year, it is normal for HMRC to make amendments to the code and the system in order to deal with tax or budget events. The implementation of those changes goes through significant testing both prior to implementation and post-implementation, and that is a key focus for our audit.

With the implementation of the Scottish rate, we are extending our testing to include people with the relevant Scottish flag to make sure that the requisite testing is done in that area. Provided that Scottish taxpayers are correctly identified, as the C and AG said, we expect the systems and processes to be able to accommodate the change to which you referred.

09:45

Alex Neil: So you think that the systems are already robust enough to identify anyone who tries to dodge tax between Scotland and the rest of the UK.

John Thorpe: We think that the department needs to keep looking at that because, as the tax system evolves—

Alex Neil: But what about as things stand? I understand that you need to keep that under review, because those guys have all their accountants constantly working on the issue but, as things stand, are the systems sufficiently robust for this year?

John Thorpe: The systems were wholly aligned for this year. Change has come through in 2017-18, and greater changes will come through in 2018-19. That changes the environment and the risk profile. We would expect HMRC, as it does, to reassess that risk as part of its normal business. We will look to see how it has done that and what it has concluded.

Alex Neil: Right. So you will keep that under constant review, as well.

John Thorpe: That is a normal part of our audit for any tax, whether in Scotland or the wider UK.

Alex Neil: Okay. I presume that, if you gather evidence that people are deliberately trying to dodge tax and are using the differential between Scotland and the rest of the UK, you will suggest and discuss rectifying measures with HMRC.

Sir Amyas Morse: Yes, but I have a clarifying comment on that. You mentioned dodging tax. Will you be clear about what we are talking about? If we are talking about tax evasion and people deliberately concealing the fact that they are Scottish residents, that is one question. If somebody is telling lies or deliberately concealing what they are doing, the systems will not necessarily prevent that. We are simply saying to members that the majority of people do not do that. We think that the system is getting better and is now achieving improved, although not perfect, reliability in identifying people who are actually resident in Scotland. However, that issue is different from the issue of whether people are evading tax—that is to say, doing things that are illegal and telling lies—or otherwise.

You also referred to avoidance. That involves people trying to legally arrange things to put themselves outwith the scope of Scottish tax. Frankly, the systems have nothing to say about that.

To be clear, quite a lot of threats could occur in other ways that will not be dealt with by the administration of the Scottish rate of income tax.

Alex Neil: You said that the system has nothing to say about avoidance. I am interested in that.

Sir Amyas Morse: It does not. If somebody comes up with a tax wheeze—if you will forgive the term—in which they say that they used to have a company or used to be resident in Scotland, but now have some way of establishing a credible legal argument with which they are successful that they are actually resident in England, they will be resident in England. That would not astonish me if a big differential in tax rates was involved. The systems will crunch that out.

I am sorry, but I am just being clear that the question is “What is the agreed status?” If there is a significant differential, people who work in London and have a home in Scotland will naturally think about whether there is a way in which they can present themselves as resident in London. That sort of stuff might occur if the differential is great enough, and the systems will not automatically address that. I am just making it clear that that is not their job.

Caroline Gardner: It is also worth noting that non-savings, non-dividend income is devolved to Scotland from 2017-18. Therefore, if people are able to properly reallocate their income from earned income to one of those categories—to savings or dividends—there will be another movement there. That falls very much into the category that my colleague has described to members.

Alex Neil: Let me give a practical example. Suppose that I earn £150,000 or £160,000 a year.

Sir Amyas Morse: Congratulations.

Alex Neil: There is no chance in this job, I can tell you.

Let us suppose that I claim that I now live in England and, therefore, pay the lower rate of income tax—I do not pay the new 46p rate in Scotland; I pay the 45p rate that is still the case in England—but, simultaneously, my kids get free tuition or I get free prescriptions in Scotland. Would your systems pick up that contradiction?

Sir Amyas Morse: They are not my systems. I am the auditor and will stick to doing audit, if that is all right.

Alex Neil: Well, are you satisfied—

Sir Amyas Morse: Let me answer you to inform the committee as best I can.

It would be very relevant for HMRC to examine any sudden transfers of status and data on that. HMRC is getting pretty good at data comparison, so I hope that it would approach oddities in that way. If it is possible to predict any likely threat to tax income, I would expect HMRC to take an intelligent approach to that and it would be great to talk to it about how it would go about that.

Alex Neil: Okay. You think that HMRC's systems are robust enough to pick up and flag up where that might happen.

John Thorpe: There are two aspects to that. The systems that we have been talking about are basically tax processing systems. They are the automated processing systems with which all of us come into contact. Layered on top of them is the compliance process, which we have been getting into. On that, HMRC has a choice about where it devotes its resources for examining and cracking down on risks of those types. The C and AG commented on the use of data, and that is where HMRC can use its data to pinpoint such risks and where it has a decision to make about where it devotes its resources.

Alex Neil: However, as things stand, the National Audit Office is satisfied that HMRC's current systems are sufficiently robust at the moment.

John Thorpe: Yes, in the automated processing they are, as long as we get the taxpayer address materially correct. The department has learnt a lot in the past 18 months as it has gone through data matching processes to clean and validate the database. In some of the validation, it has perhaps being seeking to validate against data sets that are inferior to its own, which has slowed down the process and required manual intervention. However, it now has that knowledge. How the system works going forward will be important for maintaining and improving the position.

Alex Neil: My final question is on a slightly different matter. In evidence yesterday to the Scottish Parliament's Finance and Constitution Committee, it became obvious that issues are already emerging with the interaction between our powers over income tax and the UK's residual powers over it. We are responsible only for rates and bands; the UK Treasury is responsible for policy on allowances, reliefs and, as the Auditor General said, income tax on dividends and savings.

The first of the two examples that came up yesterday was that, as a result of the decisions that our Cabinet Secretary for Finance and Constitution has made and the proposals that he has advanced, there is a big issue with whether people in Scotland will be able to get the marriage allowance and at what point in the system they will be able to do that.

The second example concerns the degree of progression in the system. The interaction between allowances and our new bands means that, at middle income—I think that it is £45,000 to £50,000—people pay a greater percentage of income tax than if they earn slightly above that. I might have the figures slightly out, but the principle is that is everything is progressive apart from for that narrow but significant group of people.

The sequence has to be that the UK budget comes before the Scottish budget because, under current arrangements, our budget cannot be set until we know what is in the UK budget. I know that the witnesses are not responsible for policy, but there is a process issue that needs to be addressed in the interaction within the division of powers on income tax and the unintended consequences that have already arisen. Will the Audit Scotland and the National Audit Office consider that?

Sir Amyas Morse: The answer to that is no, if you will pardon me for saying so. I think that that is a matter that needs to be addressed with HMRC; I do not think that it is within my competence. I do not mean that I would not try to help to inform any conclusions that were being reached, but it is not my job to lead that debate. I am not unsympathetic to what you are talking about—it is just that it is not my business.

Alex Neil: Is that your position, too, Auditor General?

Caroline Gardner: It is an issue that we cannot look at, because those sorts of interactions and the anomalies and unintended consequences that you have hinted at are a direct result of the settlement that came out of the Smith commission, the Scotland Act 2016 and the fiscal framework, and it is clear that those are policy matters that are outside my remit. They are very important—as you say, they will affect the timing of the budget and the way in which it is passed, as well as its impact on real people: taxpayers, citizens and service users.

As the new powers begin to be used and we see the full devolution of the VAT provision with the assignment of revenues and start to look at the interaction with the welfare system, there might be a need for the two Parliaments to step back and look again at the way in which they work in practice.

Alex Neil: Perhaps the committee should flag up the issue to the Finance and Constitution Committee as one that it might want to address.

The Convener: We can certainly consider that. Have you finished your questions?

Alex Neil: Yes, thank you.

Colin Beattie: Having looked at the report, I have quite a few questions and quite a few concerns about the accuracy of the Scottish tax base figures. There are a few issues that jump out. Paragraph 1.9 highlights an issue that has already been mentioned, which is that savings and dividends are affected by UK tax laws, whereas the Scottish tax thresholds are under the control of the Scottish Government. It says:

"The Chartered Institute of Taxation and Association of Taxation Technicians told us that this increases the risk of errors in self-assessment income tax."

The changes that will take place, assuming that the Scottish budget remains as it is, will significantly increase that risk. What steps can be taken to mitigate that?

Sir Amyas Morse: I am terribly sorry, but I am going to sound a bit like a cracked record. I like to be forthcoming with committees, and I am being as forthcoming as I can be here and I note that what you say is true, but it is for HMRC to talk to you about how it proposes to mitigate that risk. We are talking about how effectively HMRC is administering things: we think that there will be an issue in the future. The question for HMRC is how it expects to mitigate that risk.

Colin Beattie: Will you continue to monitor that from an audit angle?

Sir Amyas Morse: We will—absolutely. We have tried to put in our report everything that we think might be relevant to the committee's consideration. Even if it is not our job to address an issue, we will monitor it and keep you informed on it.

Colin Beattie: Paragraph 1.11 is about tax codes. I was concerned by the statement:

"HMRC and the Scottish Government have not agreed any minimum period between the finalisation of the Scottish budget and the start of the tax year."

Is that another risk?

John Thorpe: We believe that that is an issue that could give rise to some confusion. Some taxpayers could receive two coding notices within a short space of time, which is not helpful from the taxpayer's perspective. We will continue to examine implementation of the measures and their incorporation into the tax system. I know that HMRC has looked at that aspect of the administration, partly because the Scottish Government asked it to do so. We will keep the matter under review.

Colin Beattie: I will move on to the small print. According to a footnote to paragraph 2.13, we are talking about an increase in income tax of £127 million and a deduction of £20 million in respect of a block-grant adjustment. What is that?

John Thorpe: That might be a question for Audit Scotland to answer. We were trying to illustrate the fiscal impact of the changes that are being implemented for 2017-18. We have yet to audit that outturn, which is our responsibility. The paragraph simply seeks to illustrate the estimation of the budget impact of the tax changes.

10:00

Colin Beattie: That is fine, but what is the £20 million block-grant adjustment? Is it a result of the increase in tax? Is it some sort of clawback?

Caroline Gardner: Mark Taylor can help you with that.

Mark Taylor (Audit Scotland): We can write to you on the specifics, but just to give you a feel for what is going on, the net calculation of the £107 million adjustment included a forecast assessment of the difference that the change in the higher-rate threshold would make to tax collection. At the same time, the underlying assessment of the forecast position in relation to tax as a whole was revisited. Those two adjustments were put through at the same time, and that is where the £107 million came from. We can write to the committee with some of the details of that.

Colin Beattie: Did the Scottish Government budget for £127 million but get only £107 million?

Mark Taylor: No. The Scottish Government budgeted to get £107 million. The way in which the system operates during the financial year is that that is the amount that is confirmed within the budget.

Colin Beattie: Okay.

We are talking about risk models. That, of course, is an essential part of HMRC—it lives and dies by the risk assessments that it makes. Paragraph 3.25 states that

"it has adapted its standard risk model to cover Scottish-specific tax risks".

Given the changes that are taking place within the Scottish tax system, will HMRC have to revisit that model?

Sir Amyas Morse: Maybe it will, but—I apologise for saying this again—I think that you should ask HMRC about that, because you want to nail down exactly what it is going to do. We did not say that as a criticism; we are simply saying that HMRC has a list of things that it specifically models and a list of things to which it applies a general model. At the moment, it is applying the general model. You want HMRC to move to modelling risk specifically for the SRIT, which will be good from your point of view. You need to have that conversation and move it over the edge. You need to be quite sure about what you will get, against what it might cost. HMRC is charging for this, so I would get an estimate from it at the same time, if I were you.

Colin Beattie: Convener—I assume that we can have HMRC at committee to pick up some of these points.

The Convener: I have already noted the need for communication with HMRC. Iain Gray is next.

Iain Gray: Alex Neil covered what I was going to ask about.

The Convener: Okay. Liam Kerr has a question.

Liam Kerr: I will pick up on what Alex Neil said about residence. It is something that I have been interested in for a while. A Scottish taxpayer is someone who has their main place of residence in Scotland. That is quite a tight definition; it is not extensive. A "place of residence" is somewhere that one resides for at least 183 days, I understand, and one resides there—at least according to tax records—if one self-reports as residing there. It seems to me that it would be rather straightforward, particularly for higher earners, to undertake tax planning in a different way. Am I reading that correctly?

Sir Amyas Morse: A million years ago, I was a tax partner, so you will hear extremely out-of-date comments here, but I will have a go. The question of where a person's main residence is, in tax law, is helpfully described as "a matter of fact". That means that they cannot just say that a place is their main residence for a specific purpose—it has actually to be their main residence. There are a number of indicators that a place is a main residence, to do with permanence and being established.

If a person has a house in Scotland and is working and staying in a flat in London and suddenly decides to say that the flat is their main residence, HMRC has grounds to examine whether that claim is genuine. There is quite a lot of tax law on that, which built up mainly in establishing whether people were resident in the UK for tax purposes. People cannot do whatever they like; it is not like that. There is a body of tax law to test that.

Liam Kerr: It would not be outwith the realms of possibility for me to base myself in Newcastle for 183 days of the year, as a matter of fact, and to work every day over the border in Scotland while being an English taxpayer. That would be possible.

Sir Amyas Morse: If you want to use that extreme example, if you had no residence other than the one that was located in England, the only way in which that could be addressed would be through questioning whether there was deliberate avoidance of some kind.

Those are really questions for HMRC and not for me. I am just trying to give you an indicator. One could try to show that a residency that a person has adopted is a sham, but if someone is genuinely prepared to go and live in another country permanently, they will be able to establish residency in that country. You cannot really prevent people from doing that. That is probably all that I can say on the matter.

Liam Kerr: I will move on to the costs of administering the system. The report shows an administrative cost for last year of £6.3 million, which is, I understand, back-charged to Scotland. The report is fairly clear that that cost is a function of differing tax rates, in the sense that the greater the difference between jurisdictions' tax rates, the more administrative costs will be back-charged to the Scottish taxpayer.

There was a fairly recent announcement that we are going to have a greater number of tax bands in Scotland. What is the impact on the £6.3 million—or any other administrative charge—of having more tax bands? Is it possible to say that five tax bands will equal £X administrative charge, for example? How much will this cost us?

John Thorpe: The proposed changes were announced in the budget, which came after the report, so we have not had a conversation with HMRC to understand the impact or how far HMRC has got in making that assessment. That is a question to put to HMRC. We will audit the costs and ensure that the governance and capturing of those costs are accurately and properly reported.

There are two cost drivers. We talked earlier about the automated processing of returns. The system is geared up to handle that. I imagine that processing a return against an algorithm that is looking at five tax bands will not really be different from doing so against three tax bands because the operations are, effectively, the same.

We talked about divergence, whether from a Scottish decision or a UK decision, that promotes the risk of non-compliance or of behaviours that might lead to people electing to move from Scotland to England or otherwise. There would be an additional cost to that if HMRC decided to ramp that up because the risk profile changed. That would be a cost driver to which the C and AG alluded in an earlier response.

Liam Kerr: If I am hearing you rightly, you are saying that there is a set-up cost, and that once the system is up and running, it should be fairly self-operating without too much administrative cost, but that the activity decisions that are taken by HMRC might have a cost to the Scottish budget, and because they would be around enforcement and decisions taken at the time, that would not matter.

John Thorpe: That is exactly right. We have tried to capture that in figure 15, which shows the costs of implementation over time against running costs. Looking at that, you can see that implementation costs are now dropping; that is because the system has been put in place and the initial taxpayer identification exercises have been conducted. Based on what we knew at the time and on HMRC's estimates, it was predicted that, in 2018-19 for example, the overall costs would go down to just over £2 million, with the balance of that shifting into running costs rather than implementation. If there are significant changes, that projection could change.

Liam Kerr: I understand. Thank you.

The Convener: If I can just clarify for the public, Mr Kerr, you are an MSP and therefore, according to my flowchart, a Scottish taxpayer, just like Scottish MPs and MEPs. You cannot relocate to Newcastle, although others might intend to do so.

Willie Coffey: Mr Thorpe, I appreciate the explanation that you gave to Mr Kerr of the potential additional cost. The issue seems to be more to do with monitoring and tracking behavioural change than it is to do with changes in the rates and the bands. Will you clarify whether that is what you meant? The software procurement aspect of this work has probably been the most costly aspect. I think that you mentioned in your paper that about three quarters of the costs were related to information technology. Is the system flexible enough to cope with any changes that might be made to bands, rates and so on?

John Thorpe: That would be a good conversation to have with HMRC. I believe that there is capacity to incorporate further bands within the NPS system that was implemented in 2010.

Sir Amyas Morse: If HMRC wanted to ask you for more money for implementation above what was planned for, it would need to show that there is an actual differential cost. We cannot think of anything of that nature, but it is not impossible that it could come up with something that genuinely was an additional cost. However, given that the systems that it has are quite robust and flexible, we do not think that that is likely.

Willie Coffey: The committee seems to have spent a huge amount of time in recent years considering IT procurement issues, and Audit Scotland has been very much involved in those considerations. Do you play a similar role in relation to the fitness for purpose of IT systems in the rest of the UK? Does the NAO have oversight with regard to whether the system is capable of delivering what the originator says it is capable of delivering?

Sir Amyas Morse: We are fortunate enough to spend a lot of time looking at IT. I do not want to take away from the assurance that we are giving you. We are saying that we think that the system should be able to deal with different rate bands.

Willie Coffey: It should be, but is it?

Sir Amyas Morse: As far as we can see, it is.

John Thorpe: That is correct.

Willie Coffey: Were you involved in the process at the point at which HMRC failed to identify 420,000 Scottish taxpayers?

John Thorpe: We were reviewing the process as auditors, and we saw that a key control point in the system implementation involved properly identifying the Scottish tax base rate. Although I was not directly involved in the earlier reports, I know that it took some time—it was an iterative process and there was some learning during that time. HMRC did a number of things to try to validate that tax base and learned a lot through that process about whose data is correct and who has the most accurate information.

Willie Coffey: Was the failure to identify 400,000 people an IT issue?

John Thorpe: Only in so far as HMRC was using IT processes to support what it was doing. HMRC would take a database from the Post Office or whatever and run it against its own tax records in order to identify differences. However, when it identified differences, it did not know whose records were correct. That was part of the learning process, as investigation was required. There was an element of manual examination.

10:15

Willie Coffey: Were you involved in that scrutiny at the time?

John Thorpe: Yes, we had access to the whole process.

Willie Coffey: Who identified the missing 400,000 people? Was it you guys or was it HMRC?

John Thorpe: It was not a case of the audit saying, "You've got this wrong"; we just became aware that there was an issue. Indeed, I think that we talked to colleagues in Audit Scotland about it, too.

Willie Coffey: Is the memorandum of understanding between the National Audit Office and Audit Scotland now in place? Are you both satisfied that the arrangements for managing the process are in place?

Sir Amyas Morse: Yes.

Willie Coffey: How does it extend to any potential dispute or conflict resolution? What is the process in that respect?

Caroline Gardner: As Sir Amyas Morse has indicated, the memorandum of understanding has been in place for three years now, and from both points of view it is working very well. Working relationships are good, and my team and the C and AG's teams work closely together. It is all helped by the fact that we take similar approaches to audit—for example, we use the same electronic working papers package.

As for our ability to give you assurances at this stage that what you need is in place, I have said to the committee that, as the remainder of the Scotland Act 2016 provisions come into effect with the devolution of all non-savings, non-dividend income tax and VAT and with the introduction of the new welfare powers, it would be worth reviewing the matter. I know that the two Governments are doing that at the moment. Nevertheless, we are satisfied with the way that things are working just now.

Willie Coffey: Has the MOU been published? I cannot recall whether it has.

Caroline Gardner: We attached it to the committee papers either last year or the year before, but we can certainly let you have it again. It is on our website and in the public domain.

Sir Amyas Morse: On the question of dispute resolution, we would all look a bit ridiculous if we were to come before you not agreeing on something, and that is an extremely strong inducement for us to reach agreement on everything. Audit Scotland has to report to you on whether we have done the audit properly, and it would be very unsatisfactory if there were any risk of its saying that it did not think that we had. I do not recollect whether there is a dispute resolution clause in the MOU, but the dynamics of the situation in which we carry out our work are such that it would be inconceivable for us to go forward in those circumstances. We just would not allow such a situation to continue.

Caroline Gardner: The MOU actually contains a clause saying that we would have to sort it out, and you have our assurance that we would do so.

Willie Coffey: Thank you for that.

The Convener: Thank you very much for your evidence today—[*Interruption*.] I am sorry, Colin.

Colin Beattie: I do not think that Bill Bowman has asked his questions.

The Convener: Do you have a final question, Bill?

Bill Bowman: Yes.

The Convener: On you go.

Colin Beattie: I have some questions, too, convener.

The Convener: Okay.

Bill Bowman: Just for information, I should say that Sir Amyas Morse and I started our accounting training in the same firm here in Edinburgh, 40 years ago. However, our careers have diverged since then and we have ended up somewhere different.

Sir Amyas Morse: I cannot help but notice, though, that we both look extremely youthful. [*Laughter*.]

The Convener: Colin Beattie has a question.

Bill Bowman: I was going to ask a question, too, convener.

The Convener: Oh, were you? I thought that you just wanted to make that comment.

Bill Bowman: I think that someone said that there are something like 2.4 million Scottish taxpayers. Do you actually have to pay tax to be a Scottish taxpayer?

Sir Amyas Morse: Not necessarily, because we are talking about a potential, not an absolute, number. You do not need me to tell you this, but a self-employed person who had a lot of tax losses and therefore did not have to pay tax, say, would not stop being a Scottish taxpayer.

Bill Bowman: Someone on a state pension that was covered by their allowances would still be a Scottish taxpayer without paying any tax.

Sir Amyas Morse: That is right.

Bill Bowman: Do we know how many people do not really pay tax in cash terms?

John Thorpe: I do not know, but we can find that out for you. We have the information, but I do not have it readily to hand.

Bill Bowman: I would find that interesting.

Alex Neil: You have nothing to declare on that basis, Bill. [*Laughter*.]

Colin Beattie: I have three quick questions. I was quite concerned to read in paragraph 17 of the summary of the report that

"HMRC does not know how many of the cross-border moves are captured each year."

Surely that is vital. Surely HMRC's efforts to compensate by checking that information against other databases must come with a considerable cost.

Sir Amyas Morse: Yes. We flagged that up because, at the moment, the law does not require people to report to HMRC when they change address. That probably did not matter much in the pre-devolution environment, but it makes quite a big difference in the context of the Scottish rate of income tax. That is not in the law at the moment, so all that HMRC can do—as far as we can see, it is doing this a lot—is say that, on the basis of all the evidence that it has, it is doing its best to identify Scottish taxpayers and is communicating to remind people who might potentially be Scottish taxpayers of their duty to register, encouraging them to do so.

That does not change the fact that, if a person is not obliged to record where they live, there will be a bit of a gap in the system. Over time, it would be helpful to Scotland to have that requirement in place. It is way beyond my remit to say that, but we said what we said because it is relevant to understanding the situation.

John Thorpe: There may be compensations. Within the pay-as-you-earn system, in which employers ultimately capture that information, there may be the ability to catch up over time. In other areas, perhaps that would be brilliant. In self-assessment, the mitigations may take longer to kick in.

Colin Beattie: Paragraph 2.12 is on sample data, which all seems fairly uncertain. The

"2.5% above or below"

HMRC's

"central estimate of revenue"

is quite a lot of money.

John Thorpe: The basic point that we tried to draw attention to is that a number of forecasts and estimates have had to be made in the personal tax model that HMRC uses. We have suggested that, as more information becomes available—as we went through the identification exercise, we got better information in the pay-as-you-earn system through the flagging—that will be an invitation to look at whether there are better and more resilient data sources to support the forecasting exercise. We are getting into fiscal issues in Scotland, which are issues for other people, not the NAO, but those forecasts are important because they support quite significant decisions. Having got better information out of the pay-as-you-earn system, the question is whether that will support a better forecasting approach. We do not know that.

Colin Beattie: Will the possible changes that might come as a result of the coming budget make things more complex or change the way in which sampling is done and the estimates that we are talking about?

John Thorpe: We have not spoken with HMRC specifically about the coming budget changes and how they will play into things.

Going back to my first point, as the data improves, there will be an opportunity to look at whether the forecasting can be improved by drawing on the new information.

Sir Amyas Morse: Is that an area for the committee to keep pushing forward on? There are a lot of developments in information technology, big data and all that sort of stuff these days, and that might help the committee to get a clearer view of a lot of these things in the not-too-distant future.

I will keep talking to HMRC and asking it where we are going. Models are not perfect as a method of predicting. It is not evil that they are not perfect; that is just inherent in modelling. As a predictor, a model is not 100 per cent accurate, but the model that we have at the moment is quite accurate.

Colin Beattie: Paragraph 3.41 focuses on pension providers. I know that the matter has been discussed before, but I found it astonishing that paragraph 3.44 says:

"There is no definitive list of pension providers".

Surely pension funds are regulated and you can just ask the regulator for a list.

John Thorpe: I cannot really answer that question. It is a good question. We drew attention to the fact that, for the tax system to work effectively for people, there must be good co-ordination between HMRC and the pension providers. A number of steps that we tried to draw out in the report are being taken to improve that, certainly from a digital perspective. When we inquired about who the members of that population are, we did not get a clear answer, so we might need to come back to that.

Colin Beattie: A huge number of pensioners must receive pensions from companies that are based in England.

John Thorpe: Yes.

Colin Beattie: However, we do not have that figure. Your report says that

"pension providers do not necessarily know whether their members are Scottish taxpayers."

John Thorpe: That is quite an important issue, which we will continue to pursue with HMRC.

Colin Beattie: Is it a real problem or is it just an apparent problem?

John Thorpe: It is difficult for me to answer that question. The pension provider issue is probably more of a peripheral one in terms of the fiscal impact, but it does impact on individuals. How relief at source works and is implemented could bear on the individual.

Sir Amyas Morse: There might be quite a lot of unhappy people who do not get pension tax relief at the point at which they receive their pension. To repeat John Thorpe's point, it is not necessarily a matter that will hurt the Scottish exchequer, but it is a matter on which there might be a great deal of noisy complaint from people who do not get the right level of tax relief initially.

Colin Beattie: I presume that many pensions will not push people into different tax bands because, by nature, many people's pensions tend to be quite low. I presume that the pension of someone who works for a company such as BT will be paid out of London. Are we saying that such companies cannot necessarily identify whether the people who are paid the pension are Scottish taxpayers? That is my reading of what the report says. Am I misinterpreting it?

Sir Amyas Morse: We do not know the answer to that. I am not being simplistic. That is a question for HMRC to answer, and we are not clear that it can answer it yet.

Caroline Gardner: I have a wee point of clarification. I think that the issue relates to tax relief on pension contributions rather than tax relief when people receive their pension payments. As the C and AG said, there is a risk that they will not receive the full relief when they make their contributions. That will be sorted out later, but the issue does not affect pension payments that are made to people once they have retired and started drawing their pensions.

Colin Beattie: So, we can identify the residency of people who are being paid pensions. That is not at issue.

Caroline Gardner: Absolutely—we can do that as part of the identification of Scottish taxpayers.

The Convener: We will need to discuss our communication with HMRC on some of the issues that have come up today. I thank the witnesses very much for their evidence and for coming to our meeting.

We have agreed to take today's work programme discussion in private. I seek members' agreement to take next week's work programme discussion in private, too. Is that agreed?

Members *indicated agreement.*

The Convener: That means that next week's meeting of the Public Audit and Post-legislative Scrutiny Committee will be held entirely in private.

10:28

Meeting continued in private until 11:22.

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