

Public Audit Committee

5th Meeting, 2023 (Session 6), Thursday, 9 February 2023

Administration of Scottish income tax 2021/22

Introduction

1. At its meeting today, the Public Audit Committee will take evidence from the Comptroller and Auditor General (C&AG) and the Auditor General for Scotland (AGS) on the [National Audit Office report on the Administration of Scottish income tax 2021-22](#) and the [assurance report from the Auditor General for Scotland](#). Both reports were published on 12 January 2023.

Background

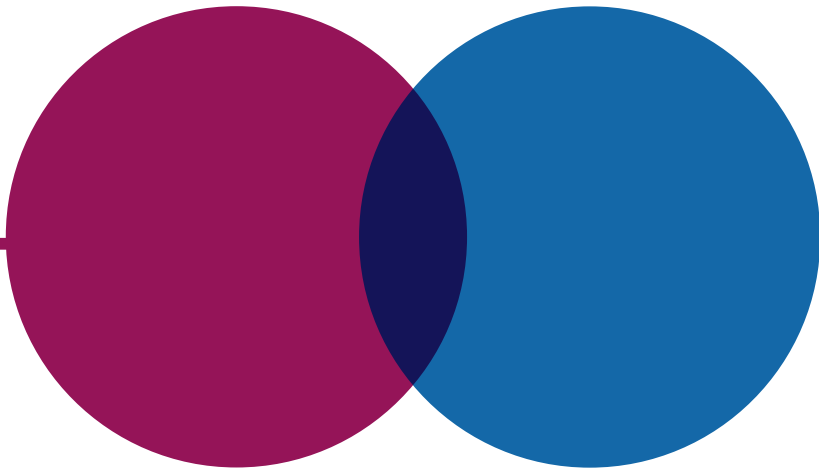
2. From April 2016, the Scottish Parliament set a Scottish rate of income tax and from April 2017 onwards, the total amount of non-savings, non-dividend income tax collected in Scotland is paid to the Scottish Government. HM Revenue and Customs (HMRC) collects and administers Scottish income tax. HMRC's accounts are audited by the National Audit Office (NAO).
3. The C&AG is required to report to the Scottish Parliament on HMRC's administration of Scottish income tax. His eighth report on Scottish income tax for the reporting period 2021-22 can be found in **Annexe A**.
4. When the predecessor Public Audit Committee published its report, [Framework for auditing Scottish income tax in 2014](#), the Committee recommended that the AGS should provide additional assurance on the NAO's audit work. The report and an accompanying briefing paper from the AGS can be found in **Annexe B**.

Consideration of the Administration of Scottish income tax 2020/21

5. The Committee considered the [NAO's 2020/21 report on the Administration of Scottish income tax](#), alongside the [AGS's assurance report](#) at its meeting on [3 February 2022](#), where it heard evidence from the C&AG and the AGS.
6. Following the evidence session on 3 February 2022, the NAO provided the Committee with further information in writing.

7. The Committee [continued its scrutiny on 12 May 2022](#), when it took oral evidence from the Scottish Government and HMRC.
8. Following the evidence session on 12 May 2022, the Scottish Government and HMRC provided further written evidence to the Committee. On receipt of this additional written evidence, the Committee wrote to both organisations seeking further information on compliance, debt management, Scottish Fiscal Commission forecasts and the use of estimates.
9. All related correspondence can be accessed via the links below:
 - [Letter from NAO, 8 March 2022](#)
 - [Letter from Scottish Government, 19 May 2022](#)
 - [Letter from HMRC, 15 June 2022](#)
 - [Letter to Scottish Government, 4 October 2022](#)
 - [Letter to HMRC, 4 October 2022](#)
 - [Letter from Scottish Government, 3 November 2022](#)
 - [Letter from HMRC, 3 November 2022](#)
10. The Committee will decide any further action it wishes to take after it has taken evidence from the C&AG and AGS.

Clerks to the Committee
6 February 2023




REPORT

Administration of Scottish income tax 2021-22

HM Revenue & Customs

SESSION 2022-23
12 JANUARY 2023
HC 1022

SG/2023/15



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National Audit Office

Administration of Scottish income tax 2021-22

HM Revenue & Customs

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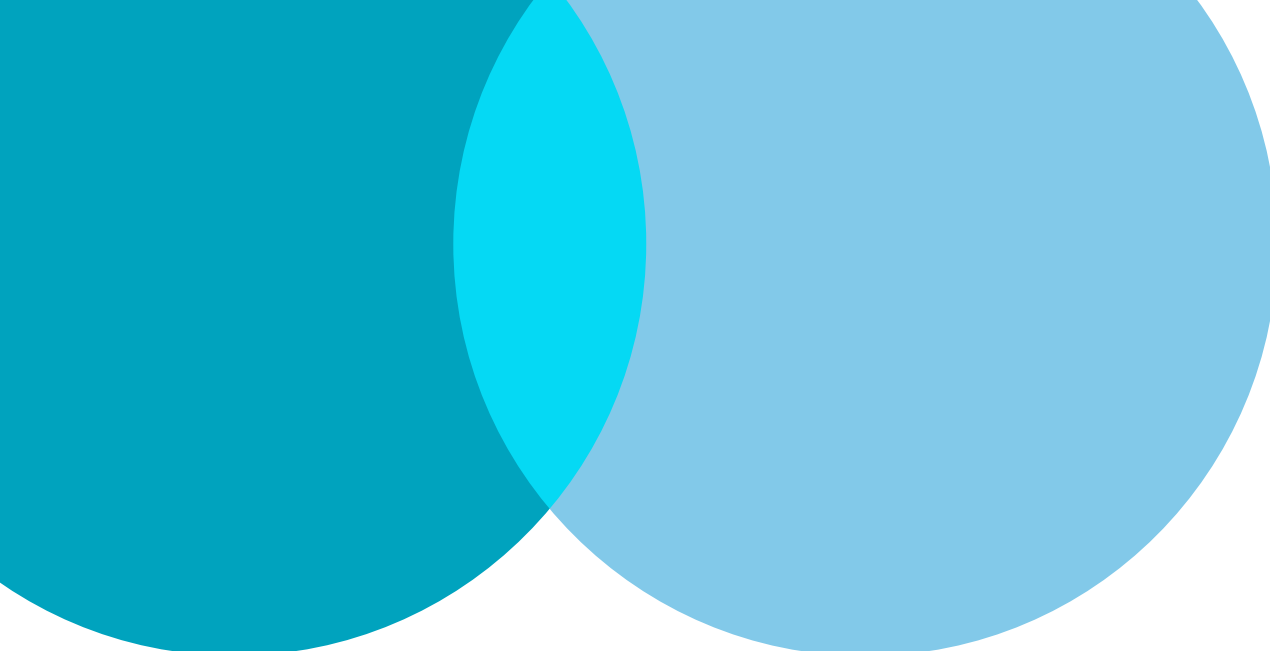
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Comptroller and Auditor General
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Key facts

2.5mn

Scottish taxpayers in 2020-21

£11.95bn

Scottish income tax revenue
in 2020-21

£13.30bn

HM Revenue & Customs'
estimate of Scottish income
tax revenue in 2021-22

£0.6 million costs of administering Scottish income tax in 2021-22

Summary

Introduction

1 The Scotland Act 2016 gave the Scottish Parliament power to determine the rates and thresholds (excluding the personal allowance) paid by Scottish taxpayers on all non-savings, non-dividend income from 6 April 2017. The Scottish Government receives all income tax revenue generated from non-savings, non-dividend income under Scottish income tax policy.

2 The Scottish Parliament sets income tax rates in Scotland using the five-band system first introduced in 2018-19. There are three tax bands in the rest of the UK. For 2021-22, the top rate tax band in Scotland stayed at £150,000. All other tax bands increased by between approximately 0.5% and 0.6%, similar to the increases for the rest of the UK (see **Figure 1**). The personal allowance, set by the UK government, increased from £12,500 in 2020-21 to £12,570 in 2021-22.

Figure 1

Income tax rates and bands in Scotland and the rest of the UK for 2021-22

There are five tax bands above the personal allowance in Scotland compared with three in the rest of the UK

Band	Income tax rates in Scotland		Income tax rates in the rest of the UK	
	Taxable income (£)	Tax rate (%)	Taxable income (£)	Tax rate (%)
Personal allowance ¹	Up to 12,570	0	Up to 12,570	0
Starter rate	12,571 to 14,667	19	-	-
Basic rate	14,668 to 25,296	20	12,571 to 50,270	20
Intermediate rate	25,297 to 43,662	21	-	-
Higher rate	43,663 to 150,000	41	50,271 to 150,000	40
Top rate ²	More than 150,000	46	More than 150,000	45

Notes

- 1 A taxpayer's personal allowance is reduced by £1 for every £2 of net income above £100,000.
- 2 This is known as the additional rate in the rest of the UK.

Source: HM Revenue & Customs, *Income Tax rates and Personal Allowances*, available at: www.gov.uk/income-tax-rates/previous-tax-years, accessed October 2022 and HM Revenue & Customs, *Income Tax in Scotland*, available at: www.gov.uk/scottish-income-tax/2021-to-2022-tax-year, accessed October 2022.

3 HM Revenue & Customs (HMRC) administers and collects Scottish income tax as part of the UK tax system. HMRC identifies taxpayers living in Scotland by applying a 'flag' in its systems that indicates they are subject to Scottish income tax rates and thresholds. HMRC has calculated that there were 2.5 million Scottish taxpayers in 2020-21. HM Treasury is responsible for paying Scottish income tax to the Scottish Government.

4 Following the end of each tax year, HMRC produces a provisional estimate of Scottish income tax revenue for that year. The final outturn is calculated the following year once HMRC receives further information from taxpayers and employers. This report covers the final outturn for 2020-21 and the provisional estimate for 2021-22. HMRC expects to publish the outturn for 2021-22 in its 2022-23 Annual Report and Accounts.

5 Section 80HA of the Scotland Act 1998, as amended by the Finance Act 2014 and the Scotland Act 2016, requires the Comptroller and Auditor General (C&AG) to prepare a report for each financial year on:

- the adequacy of HMRC's rules and procedures, in consequence of the Scottish rate provisions, to ensure the proper assessment and collection of income tax charged at rates determined by those provisions;
- whether these rules and procedures are being complied with;
- the correctness of sums brought to account by HMRC which relate to income tax attributable to a Scottish rate resolution; and
- the accuracy and fairness of amounts reimbursed to HMRC as administrative expenses.

6 This report assesses:

- HMRC's calculation of the 2020-21 income tax revenue for Scotland, the 'outturn', and assurance on the correctness of amounts brought to account (Part One);
- HMRC's estimate of the 2021-22 income tax revenue for Scotland and our view on the estimate methodology (Part One);
- key controls operated by HMRC to assess and collect income tax (Part Two);
- HMRC's approach to assessing and mitigating the risk of non-compliance with Scottish tax requirements (Part Two); and
- the cost of administering Scottish income tax. We provide assurance on the accuracy and fairness of these amounts in the context of costs incurred by HMRC (Part Three).

7 In December 2022, the Scottish Government announced that the top rate of income tax will increase from 46% to 47% and that the higher rate of income tax will increase from 41% to 42%. This will come into effect on 6 April 2023 to cover the 2023-24 tax year. The level at which taxpayers will pay the top rate of income tax will reduce from £150,000 to £125,140 for taxpayers in both Scotland and the rest of the UK. We will consider the impact of these changes in future reports.

8 Appendix One sets out our audit evidence base.

Key findings

Scottish income tax 2020-21 final outturn and 2021-22 estimate

9 HMRC calculated the final outturn for 2020-21 as £11,948 million, representing amounts collected under Scottish income tax policy. HMRC's estimate of 2020-21 Scottish income tax revenue, published in November 2021, was £12,035 million, meaning the actual outturn was £87 million (0.7%) lower than HMRC had originally estimated. We examined the methodology for the calculation of the actual outturn, which necessarily includes some remaining areas of estimation, for instance where returns from taxpayers had not yet been received. In these areas, we have evaluated the basis of HMRC's estimate, including the relevant assumptions and available data. Based on that audit work, we have concluded that the Scottish income tax revenue outturn for 2020-21 is fairly stated (paragraphs 1.2 to 1.16).

10 HMRC has estimated Scottish income tax revenue for 2021-22 as £13,295 million. This represents an increase of £1,347 million (11.3%) compared with the 2020-21 outturn. Income tax for the whole of the UK increased by 13.2% in 2021-22. The increases in UK and estimated Scottish income tax revenues reflect the recovery of the economy after the acute phase of the COVID-19 pandemic had ended. HMRC expects to calculate the finalised 2021-22 income tax outturn attributable to Scotland in 2023. The estimate HMRC produces is solely for financial reporting purposes in its annual accounts and does not affect the amount of revenue ultimately received by the Scottish Government (paragraphs 1.17 to 1.22).

11 External factors have increased the level of uncertainty in HMRC's estimate of Scottish income tax revenue for 2021-22. HMRC identified the key source of uncertainty as the accuracy with which it can estimate Scotland's share of UK income tax liabilities, particularly since this estimate relies on survey data from 2019-20. External factors outside its direct control, such as the wave of the Omicron variant of COVID-19 that developed during the year and the impact of the Ukraine conflict on taxpayers' ability to meet their tax liabilities, have introduced further uncertainty to the estimate. We consider the approach adopted by HMRC to estimating the impact of these areas of uncertainty on Scottish income tax revenue in 2021-22 to be reasonable (paragraph 1.23).

Administration of Scottish income tax

12 HMRC has adequate rules and procedures in place to ensure the proper assessment and collection of Scottish income tax and those rules are being complied with. Our work on Scottish income tax matters builds on our wider assessment of HMRC's rules and procedures, completed as part of our annual audit of HMRC. As part of that audit, we concluded that HMRC had framed adequate regulations and procedures to secure an effective check on the assessment, collection and proper allocation of revenue, and that these regulations and procedures are being duly carried out (paragraphs 2.2 to 2.14).

13 Maintaining an accurate and complete record of the addresses of Scottish taxpayers remains the key challenge in administering the system. HMRC relies on taxpayers notifying it of a change of address, although there is no legal requirement for them to do so. We found that there had been a reduction in the number of Scottish postcodes identified by HMRC's address-cleansing work as either missing or invalid, with 1% (25,488) of the overall taxpayer population identified as either missing or invalid in June 2021 compared with 2% (61,213) in September 2020. HMRC has investigated and updated those cases where individuals were either employed or receiving a pension (paragraphs 2.16 to 2.25 and Figure 8).

14 The divergence between the tax regimes in Scotland and the rest of the UK in 2021-22 remained broadly the same as in 2020-21. As in previous years, the amount of income tax paid in Scotland diverges the most in percentage terms from the rest of the UK for those earning around £50,000, although the percentage difference paid by taxpayers at that level did reduce slightly in 2021-22. HMRC continues to assess the risk of a Scottish taxpayer manipulating their address to minimise their tax liability. HMRC has not identified any significant or widespread instances of taxpayers changing their address to obtain a tax advantage (paragraphs 2.29, 2.38 to 2.41 and Figure 9).

15 HMRC continues to assess as 'low' the risk of non-compliance as a result of divergence between Scottish income tax and rest of the UK. In 2021-22, HMRC produced a Scottish Strategic Picture of Risk (SPR). It considers the main areas of risk to Scottish income tax to be the same as those compliance risks which are assessed at the whole-of-UK level. There are no risks identified in the Scottish SPR which are specific to Scotland as HMRC assesses that compliance risk in Scotland is consistent with the rest of the UK. There is a risk that this current position may not be sustainable in the longer term, particularly if further divergence of tax policy occurs. The Scottish Government did not ask HMRC to undertake any specific compliance activity in 2021-22, in addition to the work undertaken as part of its UK-wide compliance approach (paragraphs 2.28 to 2.30 and 2.38).

16 HMRC calculated a compliance yield of £280 million relating to Scotland for 2020-21, the most recent data available. HMRC measures the effectiveness of its enforcement and compliance activities through compliance yield: its estimate of the additional revenues it has generated through its compliance work, and the revenue losses it has prevented. HMRC also estimated that Scotland's share of net losses was £970 million. HMRC calculates these figures as a proportion of the equivalent UK figure, rather than using Scotland-specific data to quantify the risks. HMRC does not consider or report on geographical variations in the level of compliance risk, or the relative success of compliance activity in Scotland compared with the rest of the UK (paragraph 2.31).

17 HMRC has limited performance data available about its compliance activities in Scotland. Unlike its income tax system which flags residents as Scottish, HMRC's compliance system cannot readily identify people living in Scotland. HMRC therefore cannot easily track and monitor compliance activity in Scotland and this affects its ability to collect performance data about the extent of Scottish non-compliance (paragraph 2.33).

18 COVID-19 continued to have an impact on HMRC's compliance activities during 2021-22. Across the UK, the number of compliance cases opened and closed in 2021-22 was higher than in 2020-21 but 27% lower than in 2019-20 before the pandemic. The ability to conduct face-to-face enquiries and the need to re-deploy compliance staff to support other COVID-19 measures also affected its compliance activity during the year. HMRC's yield from its tax compliance activities for the whole of the UK was £30.8 billion in 2021-22, up 1.1% compared with 2020-21 but lower than the £36.9 billion reported in 2019-20. It will take some time to understand fully the impact of the pandemic on tax compliance and yield (paragraphs 2.34 and 2.35).

19 Tax debt has reduced since 2021 but remains higher than pre-pandemic levels. HMRC's debt balance is affected by external factors that have an impact on taxpayers' ability to pay their tax liabilities, including current inflationary pressures and increases in the cost of living. At 31 March 2022, total tax debt for the UK was £41.6 billion, 86% (£19.2 billion) higher than the level of debt reported at 31 March 2020, before the impact of the COVID-19 pandemic. HMRC expects the level of tax debt to fall more slowly than it initially anticipated. HMRC estimated Scottish taxpayers' total tax debt to be £2.0 billion as at 31 December 2021, 5.7% of UK tax debt at that time.¹ Some £0.9 billion of this was attributed to debts from Pay As You Earn (PAYE) and Self Assessment income tax. HMRC calculated this estimate in response to a question from the Scottish Public Audit Committee, with no equivalent figure being available at 31 March 2022 (paragraphs 2.36 and 2.37).

¹ Figures provided by HMRC to the Convener of the Scottish Public Audit Committee in June 2022. Figures do not sum to the total debt balance of £39.5 billion at that time because they exclude non-UK debts where the country cannot be identified. We have not audited these figures.

Costs

20 In 2021-22 HMRC incurred and recharged £0.6 million to the Scottish Government for the cost of administering Scottish income tax. We examined HMRC's method for estimating the costs of collecting and administering Scottish income tax for the year ended 31 March 2022. Based on our audit work, we have concluded that the amount paid by the Scottish Government was accurate and fair in the context of the agreement between HMRC and the Scottish Government (paragraphs 3.4 and 3.5 and Figure 10).

Part One

Income tax collected from Scottish taxpayers

1.1 Part One of this report covers HM Revenue & Customs' (HMRC's) calculation of the final revenue outturn for Scottish income tax in 2020-21 and its provisional estimate of Scottish income tax revenue for 2021-22. This includes:

- our assessment of HMRC's Scottish income tax outturn calculation for 2020-21, including data limitations and HMRC's judgements in areas of uncertainty; and
- our views on HMRC's estimate of Scottish income tax revenue for 2021-22 and the features and limitations of HMRC's methodology.

The Scottish income tax 2020-21 final outturn

1.2 HMRC's calculation of the outturn for Scottish income tax revenue for 2020-21 is £11,948 million (**Figure 2** overleaf). HMRC calculates the final outturn figure from several components, which are aggregated to produce the total Scottish income tax liability for 2020-21. Each component is calculated using one or more sources of data to extract the total Scottish income tax liability.

1.3 Figure 2 shows how the outturn for Scottish income tax has changed over time. The calculated outturn for 2020-21 represents an increase of 1.0% compared with 2019-20. The outturn for non-savings, non-dividend income tax for the whole of the UK increased by 2.0% in 2020-21.² HMRC's estimate of 2020-21 Scottish income tax revenue, published in November 2021, was £12,035 million, meaning the actual outturn was £87 million (0.7%) lower than HMRC had originally estimated.

1.4 The outturn calculation is largely based on established tax liabilities, some £12,067 million, where HMRC has finalised the tax owed and fully reconciled the taxpayer records. HMRC calculates the established liabilities from the final tax liability data extracted from the Pay As You Earn (PAYE) and Self Assessment income tax systems.

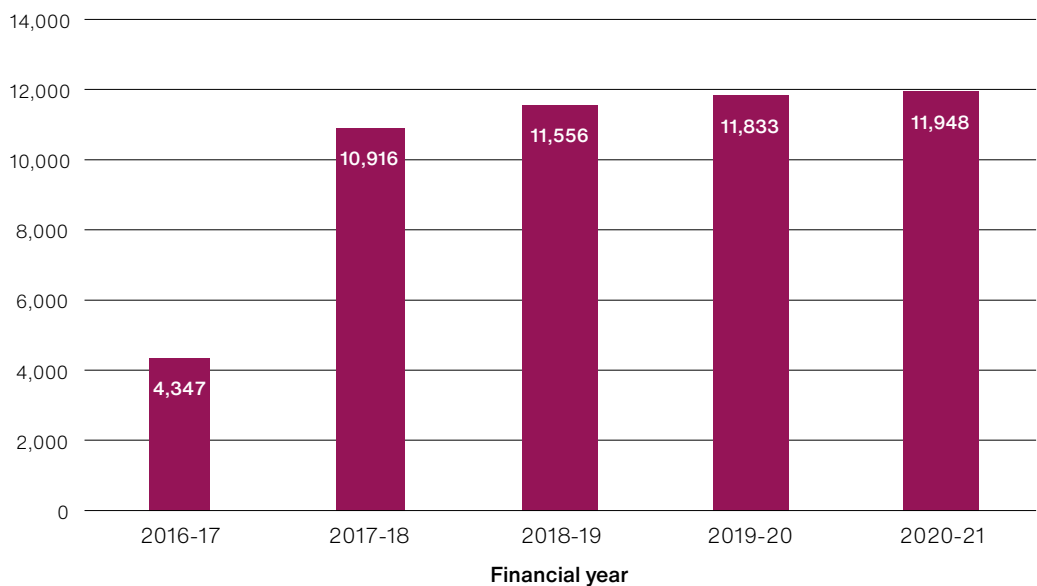
² HM Revenue & Customs, *Scottish Income Tax Outturn Statistics: 2020 to 2021*, July 2022.

Figure 2

Reported outturn for Scottish income tax revenue, 2016-17 to 2020-21

Scottish income tax revenue has been relatively stable since 2017-18, when changes made following the Scotland Act 2016 came into effect¹

Reported outturn (£mn)

**Note**

¹ The outturn for 2016-17 is substantially lower than subsequent years due to a change in the legislation governing Scottish income tax rates. The Scotland Act 2016 gave the Scottish Parliament full power to determine the rates and thresholds (excluding the personal allowance) paid by Scottish taxpayers on all non-savings, non-dividend income from 6 April 2017. Prior to this the Scottish Government could only set a proportion of the overall tax rate.

Source: National Audit Office summary of HM Revenue & Customs information

1.5 HMRC makes adjustments or estimates where tax due has not yet been finalised, or where HMRC must estimate the Scottish share of uncollectable amounts or tax reliefs. The reduction in Scottish income tax outturn arising from these adjustments was £119 million (net) (**Figure 3**). In some areas of the calculation, HMRC does not have data available in sufficient detail to identify income tax liabilities, reliefs or other adjustments relating to individual taxpayers. HMRC estimated the Scottish share of these balances by using other available data, such as population and income data, to apportion the balance between Scotland and the rest of the UK.

1.6 HMRC and the Scottish Government discussed and agreed the methodology used to calculate the 2020-21 outturn for Scottish income tax at the Scottish Income Tax Board in April 2022. The methodology used to calculate the outturn has remained broadly the same since the prior year.

Figure 3

HM Revenue & Customs' (HMRC's) calculation of the 2020-21 Scottish income tax revenue outturn

The majority of the outturn is based on established liabilities with a small proportion estimated by HMRC

	2020-21			2019-20
	Amounts based on established taxpayer liabilities	Adjustments and amounts based on estimated liabilities	Total	Total
	(£mn)	(£mn)	(£mn)	(£mn)
Self Assessment established liabilities ¹	5,173	(57)	5,116	5,049
Pay As You Earn (PAYE) established liabilities ¹	6,893	(10)	6,884	6,845
Estimated further liabilities ²	-	315	315	307
Deductions from revenue ³	-	(366)	(366)	(368)
Total	12,067	(119)	11,948	11,833

Notes

- 1 Self Assessment and PAYE established tax liabilities are based primarily on the tax liability data held by HMRC, although some amounts are based on estimates as well.
- 2 This is HMRC's estimate of PAYE tax liabilities that have not yet been finalised and where tax liabilities are expected from future Self Assessment returns or compliance activity.
- 3 Deductions from revenue include tax relief on pension contributions and Gift Aid.
- 4 Numbers shown in brackets are negative numbers.
- 5 Totals do not sum due to rounding.

Source: HM Revenue & Customs, *Annual Report and Accounts 2021-22*, HC 494, July 2022 and National Audit Office analysis of HM Revenue & Customs data

1.7 We examined the methodology for the outturn calculation, which necessarily includes some remaining areas of estimation, for instance where returns from taxpayers had not yet been received. In these areas, we evaluated the basis for HMRC's estimate including relevant assumptions and available data. We concluded that the Scottish income tax revenue outturn for 2020-21 is fairly stated. We describe the key components of the outturn calculation in more detail below.

Self Assessment established liability

1.8 The Self Assessment established liability of £5,116 million represents the calculation of all income tax attributable to Scotland from Scottish Self Assessment taxpayers in 2020-21. The calculation of Self Assessment liabilities is mainly based on the extraction of Scottish taxpayer data from HMRC's systems but with some apportionment of other balances.

1.9 HMRC identifies Scottish taxpayers using its record of Scottish residency status in its Computerised Environment for Self Assessment (CESA) system. It can identify total Scottish income tax liabilities by extracting Scottish taxpayer records from CESA. HMRC has also made minor adjustments to apportion Scotland's share of other relevant Self Assessment balances where specific data are not available.³

PAYE established liability

1.10 The PAYE established liability of £6,884 million represents the sum of all income tax attributable to Scotland from Scottish PAYE taxpayers in 2020-21. While most PAYE liabilities are based on extracting Scottish taxpayer data from HMRC's systems, some apportionment of other smaller elements is required.

1.11 Under PAYE, employers submit data monthly to HMRC on the earnings and tax deductions made for their employees and this information is recorded in HMRC's National Insurance and PAYE Service (NPS) system. HMRC identifies Scottish taxpayers in the NPS using a residency indicator based on taxpayer postcode information. By extracting Scottish taxpayer records from the NPS, HMRC can identify the total Scottish income tax liabilities. HMRC deducts from this the Scottish share of tax reliefs given against PAYE liabilities.

1.12 An adjustment is made to apportion the tax collected from employers under PAYE settlement agreements.⁴ The Scottish share calculated for 2020-21 was £19 million. As tax liabilities are settled through one payment for the employer, the identity of individual taxpayers is not recorded and therefore HMRC undertakes an analysis of employer submissions to determine the Scottish proportion of UK-wide settlement agreement revenue. HMRC was able to base this on a complete set of PAYE settlement agreement returns from employers for 2020-21, compared with the previous year when it did not receive all returns in line with the expected timetable due to the COVID-19 pandemic.

³ This includes an estimate of £29 million from manually entered liabilities and assessments, which do not provide a split of the liability between taxes. It also includes sensitive records, which are not accessed by HMRC to calculate Scottish income tax. A sum of £102 million was deducted for the Scottish share of tax reliefs claimed through Self Assessment.

⁴ A PAYE settlement agreement allows employers to make one annual payment to cover all tax due on minor, irregular or impracticable expenses or benefits for employees in the scheme.

Estimated further liabilities

1.13 Most Self Assessment liabilities for 2020-21 are established prior to calculating the outturn. Nevertheless, HMRC knows from past years that Self Assessment tax liabilities will continue to be established and collected for up to six years afterwards. This is because HMRC continues to receive additional information from taxpayers and through its compliance activity. HMRC calculates the estimated additional liability for these elements based on past performance and valued it at £305 million in the 2020-21 outturn. HMRC made an estimated adjustment of £10 million in relation to further PAYE liabilities that had not yet been determined, such as where year-end totals or information about benefits-in-kind received by the taxpayer were still outstanding.

Deductions from revenue

1.14 HMRC makes a series of deductions from the outturn revenue, recognising that not all taxpayer liabilities will be collected in practice. It uses historical information to calculate these deductions and apportions an amount for Scottish taxpayers.

1.15 Some PAYE and Self Assessment income tax liabilities are never settled because either employers or taxpayers fail to pay the full amounts due. HMRC has analysed historical data for the UK as a whole to determine patterns of uncollected liabilities and then apportioned an amount relating to Scottish taxpayers. HMRC calculated this to be £97 million for 2020-21.

1.16 HMRC makes further deductions for pension contributions and Gift Aid, both of which attract income tax relief at the taxpayer's marginal rate of income tax. Pension scheme administrators claim tax relief at the basic rate from HMRC on behalf of their scheme members, while charities claim tax relief at the basic rate from HMRC on behalf of their donors. HMRC calculated both deductions by estimating the Scottish share of each tax relief claimed across the UK using historical data. HMRC calculated the Gift Aid deduction to be £114 million for 2020-21 and pension contributions to be £155 million.

The Scottish income tax estimate for 2021-22

1.17 HMRC estimates it will collect £13,295 million of Scottish income tax revenue relating to the 2021-22 year.⁵ This represents an increase of £1,347 million (11.3%) against the 2020-21 outturn. There was a 13.2% increase for the UK overall against the 2020-21 outturn. Income tax revenues increased in both Scotland and the rest of the UK in 2021-22, reflecting the recovery of the economy after the acute phase of the COVID-19 pandemic had ended. The final outturn for the 2021-22 year is expected to be published in HMRC's 2022-23 Annual Report and Accounts by July 2023. The estimate produced by HMRC is solely for financial reporting purposes in its annual accounts and does not affect the amount of revenue ultimately received by the Scottish Government.

1.18 HMRC's methodology to estimate Scottish income tax revenue for 2021-22 is based on taxpayer data from 2019-20, extracted from its Survey of Personal Incomes. Scotland's percentage share of the overall UK income tax liability is determined by analysing data in a model replicating the UK income tax system, known as the Personal Tax Model. The data are adjusted to reflect demographic and policy changes that are expected or known to have taken place between 2019-20 and 2021-22. The share is then applied to the total UK tax liability to produce an estimate of revenue for Scottish income tax (**Figure 4**).

1.19 HMRC's current methodology for estimating Scottish income tax revenue is consistent with the Office for Budget Responsibility's methodology to forecast income tax receipts for both Scotland and the whole of the UK. The methodology is also largely consistent with that used to calculate the 2020-21 estimate.

1.20 HMRC made a 'calibration' adjustment to the revenue estimate because its methodology has historically resulted in actual outturn being lower than estimated outturn. HMRC made this adjustment by comparing the 2020-21 outturn with a revised estimate of 2020-21 revenue using the same methodology but with the most recent assumptions and data. The impact of the calibration adjustment reduced the 2021-22 provisional estimate by £0.6 billion (4.4%) (see Figure 4).

1.21 The calibration adjustment is subject to the following limitations:

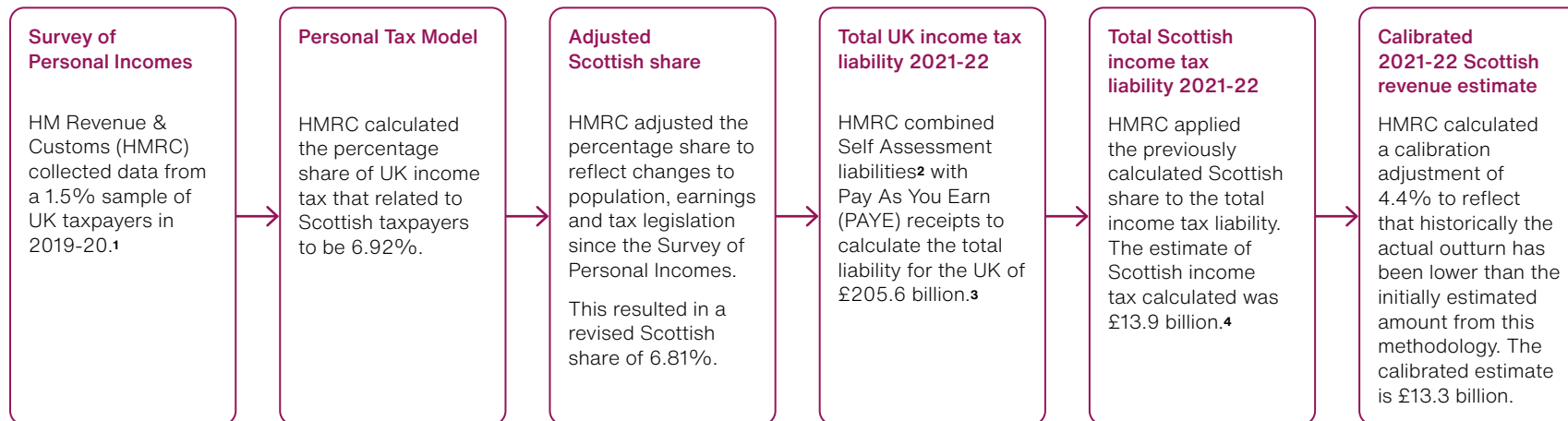
- It assumes the 2021-22 over-estimation is consistent with the over-estimation observed in 2020-21 in percentage terms.
- The causes of the over-estimate in 2020-21 are not fully understood and any socioeconomic factors contributing to it may be different in 2021-22.

⁵ HM Revenue & Customs, *Annual Report and Accounts 2021-22*, HC 494, July 2022.

Figure 4

Method for calculating the Scottish 2021-22 income tax revenue estimate

The revenue estimate relies upon sample data and an apportionment of UK-wide estimates to calculate a Scottish share of income tax revenue



Notes

- 1 HMRC's annual Survey of Personal Incomes is a sample of UK taxpayers' data from the PAYE and Self Assessment tax systems. The Personal Tax Model projects the outcome for income tax liabilities in 2021-22, adjusting for differing rates of population growth and economic factors such as wage increases, to calculate the Scottish share.
- 2 Non-savings, non-dividend income only.
- 3 PAYE data come from HMRC's Real-Time Information system. Self Assessment data come from HMRC's Self Assessment Model.
- 4 HMRC applied the previously calculated Scottish share to the total income tax liability before Gift Aid, and then removed the estimated share of Scottish Gift Aid along with other much smaller adjustments.

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

1.22 Our review concluded that HMRC's approach is reasonable. However, the limitations we described in previous reports relating to HMRC's methodology for estimating Scottish income tax revenue remain relevant for 2021-22:

- The use of sample data introduces sampling uncertainty into the revenue estimate from which the Scottish portion is calculated as a percentage.
- The methodology combines the calculation of PAYE and Self Assessment liabilities for the UK such that the amount apportioned to Scotland does not reflect the differing proportions of each type of taxpayer between Scotland and the rest of the UK.
- The data used for PAYE include all income types and do not exclude tax from savings and dividend income.
- An assumption must be made around the volume and value of under- and over-payments relating to PAYE liabilities.

1.23 HMRC identified the key source of uncertainty in the 2021-22 estimate as the accuracy with which it can estimate Scotland's share of UK income tax liabilities. The estimated share is based on 2019-20 survey data so there is an inherent risk that this could change for Scotland by 2021-22. HMRC estimates that Scottish income tax liabilities will grow at a slower rate than the UK overall. External factors outside HMRC's direct control, such as the wave of the Omicron variant of COVID-19 that developed during the year and the impact of the Ukraine conflict on taxpayers' ability to meet their tax liabilities, increases the level of uncertainty around estimating Scotland's share. We consider that HMRC has taken a reasonable approach to estimating the impact of these areas of uncertainty on Scottish income tax revenue in 2021-22.

Part Two

Administering Scottish income tax

2.1 This part of the report covers:

- HM Revenue & Customs' (HMRC's) key processes to administer the income tax system and our approach to obtaining assurance on them (paragraphs 2.5 to 2.14);
- HMRC's procedures to identify and maintain a complete and accurate record of the Scottish taxpayer population (paragraphs 2.15 to 2.26); and
- HMRC's activity to identify and respond to compliance risks (paragraphs 2.27 to 2.45).

2.2 HMRC uses the same systems to administer income tax whether it is received from a taxpayer in Scotland or the rest of the UK. However, HMRC also operates additional rules and procedures for Scotland, and we assess these below. This reflects HMRC's responsibility to administer income tax for Scottish taxpayers in the same way as the service provided elsewhere in the UK.

2.3 Under Section 2 of the Exchequer and Audit Departments Act 1921, the Comptroller and Auditor General (C&AG) must consider the adequacy of HMRC's systems to assess and collect tax in the UK, including income tax. Each year we publish a report (the Standard Report) alongside HMRC's Annual Report and Accounts setting out the C&AG's conclusions in this respect. Our 2021-22 Standard Report concluded that HMRC had framed adequate regulations and procedures to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are duly carried out.

2.4 To support the conclusions of this report, we extended our UK-wide testing to address risks and approaches arising from divergences in income tax policy. We also undertook specific procedures looking at HMRC's address-cleansing and wider tax compliance activities. These informed our assessment of the completeness and accuracy of HMRC's Scottish income tax estimates. To reach our conclusions, we examined several elements of devolved tax administration, such as the ongoing maintenance of Scottish taxpayer records, and how devolved tax compliance risks were identified and responded to.

The income tax system

2.5 HMRC's system to collect income tax is consistent across the UK. Depending on the type of income an individual receives, income tax is assessed and collected by employers deducting earnings through Pay As You Earn (PAYE), by the taxpayer submitting a Self Assessment return, or both.

2.6 The PAYE and Self Assessment processes share common principles, despite using different IT systems and data sources to assess and collect tax.

Figure 5 identifies these principles and describes the main processes for each income tax stream.

Assurance of income tax processing

2.7 Our annual audit work programme on HMRC includes procedures providing assurance over key tax processing controls. These controls are broadly divided into two categories:

- automated system controls around data-handling, storage and processing; and
- complex key business controls that have a high level of automation.

2.8 Following annual updates to business rules to reflect changing tax rates, thresholds and allowances for the UK and devolved administrations, HMRC completes several phases of assurance testing on key business controls to confirm system functionality. We evaluate the scope of this testing and re-perform elements to confirm HMRC's conclusions as part of our audit. The key processes for PAYE include annual:

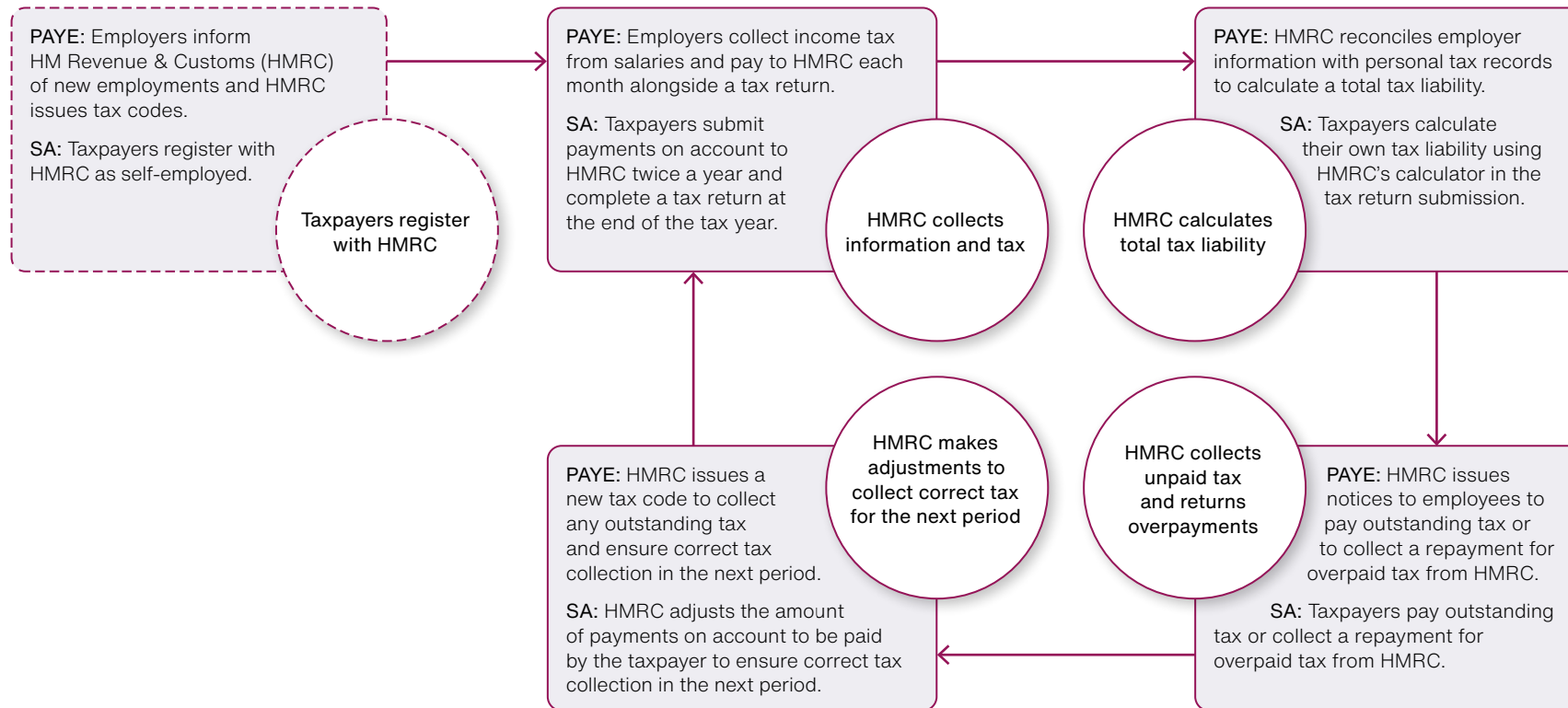
- reconciling employer information with personal tax records to confirm tax due on earnings and calculate any over- or under-payments of tax based on country of residence; and
- issuing tax codes to PAYE taxpayers which incorporate residency information to ensure employers deduct tax under the tax rules of the correct country.

2.9 Similar processes are applied to each individual Self Assessment return that HMRC receives. Self Assessment taxpayers make payments on account and at the year-end calculate their own tax liability using HMRC's calculator in the tax return submission.

Figure 5

The UK income tax system

The Pay As You Earn (PAYE) and Self Assessment (SA) processes share common principles to assess and collect income tax



Notes

- 1 Pay As You Earn (PAYE) and Self Assessment do not occur simultaneously. PAYE is processed during the tax year and reconciled after the tax year ends. Self Assessment returns are not submitted until the January following the end of the tax year.
- 2 After the tax year ends, HMRC's PAYE reconciliation process calculates the income tax liability for each taxpayer using all available data. The calculated liability is compared with amounts deducted at source or collected from taxpayers directly to determine whether the correct tax has been collected.

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

Devolved income tax

2.10 The main differences in administering Scottish income tax, when compared with UK processes, are the business rules that the HMRC system applies when completing tax liability and tax code calculations. There have been no significant changes to system rules since our last report covering 2020-21. The rules applied for Scottish taxpayers are as follows:

- The system checks the individual's residency status and applies the 'S' tax code prefix where they are identified as a Scottish resident. This instructs employers to collect tax under Scottish tax rates. Where an individual is no longer resident in Scotland, the 'S' prefix is removed.
- Where an individual is identified as a Scottish resident, Scottish tax rates and bands are applied to the reported income when calculating the liability for the current tax year.
- If an individual has been identified as a Scottish resident and is enrolled on a PAYE scheme, the system uses Scottish income tax rates and thresholds to calculate a new tax code for the following year.

2.11 Self Assessment returns include a check box for the taxpayer to state whether they resided in Scotland during the tax year. If this contradicts HMRC's records, HMRC uses the address it holds to calculate the taxpayer's tax liability. HMRC notifies taxpayers of the discrepancy and asks them to update their address if required.

Figure 6 shows where these divergences occur within the income tax system.

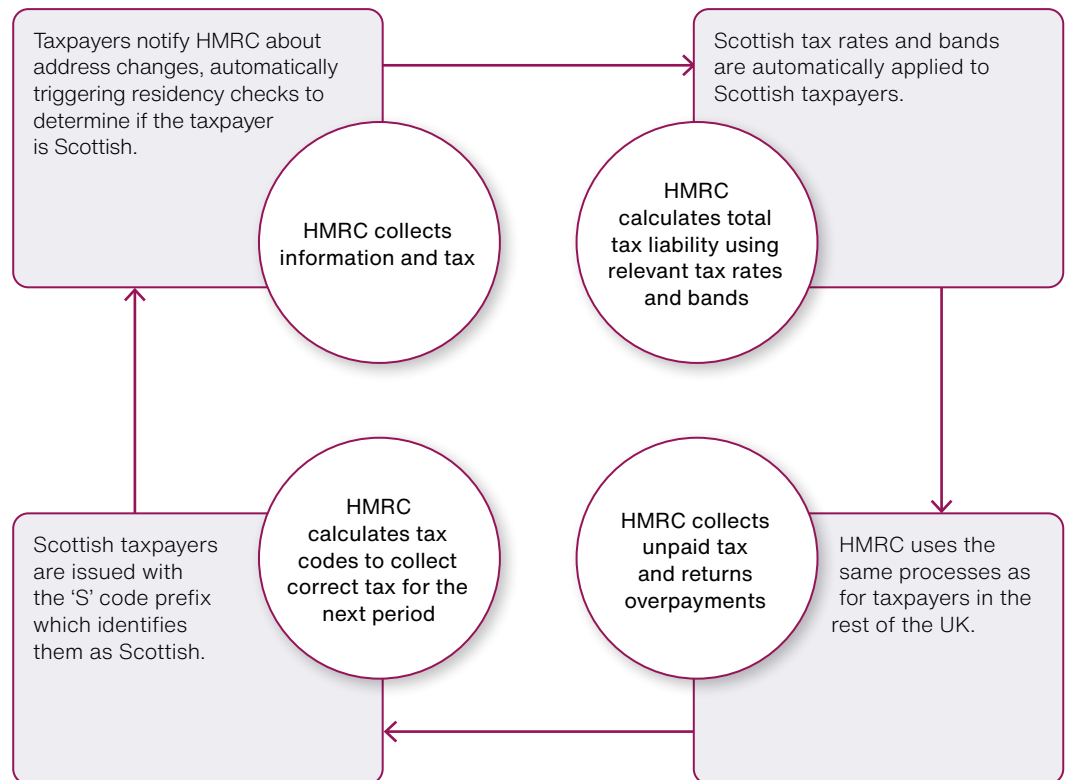
Tax relief on pension contributions

2.12 Pension scheme administrators must identify Scottish taxpayers so that tax relief is correctly allocated. Pension administrators claim tax relief at source on behalf of their members and add this to their members' contributions. HMRC's Relief at Source (RAS) system automatically confirms the residency status of pension scheme members to ensure the correct relief is applied at source. It applies tax relief on pension contributions at the basic rate of 20% for all taxpayers. Scottish taxpayers paying a tax rate above 20% can claim the remaining tax relief through a Self Assessment return or by contacting HMRC.

Figure 6

Divergences in the income tax system for Scottish taxpayers

HM Revenue & Customs' (HMRC's) business rules are configured to process income tax using the rates and thresholds applicable to a taxpayer's residency status



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

2.13 To administer relief at source, HMRC requires all pension administrators to submit an annual report listing their members' contributions during the previous tax year. HMRC's systems automatically trace scheme members and match them against addresses held to identify Scottish taxpayers. An Annual Notification of Residency Report is then issued to all pension administrators. HMRC confirmed the residency status for 93% of Scottish and Welsh pension scheme members following the 2020-21 tax year. Following the 2020-21 tax year, HMRC issued Annual Notification of Residency Reports to pension scheme administrators in January 2022.

Tax relief on Gift Aid contributions

2.14 Tax relief on Gift Aid contributions in Scotland is provided at the UK basic rate of 20%. This is because HMRC does not have systems in place to establish the residency of taxpayers donating to charity. All taxpayers paying tax above the basic rate can claim the difference between their tax rate and the basic rate on their donation. Where donations are made by Scottish taxpayers, the correct rate of relief is applied when HMRC is notified of the donated amount either through a request to amend a tax code or via a Self Assessment return.

Scottish taxpayer population

2.15 HMRC has calculated that there were 2.5 million Scottish taxpayers in 2020-21.⁶ A Scottish taxpayer is someone with a tax liability whose main place of residence during the tax year is Scotland.⁷ Higher-rate and top rate taxpayers accounted for around 15% of the Scottish income tax population in 2020-21 and contributed around 60% of tax paid. Starter-rate and basic rate taxpayers accounted for more than half of the population (51%) and provided around 11% of tax paid (**Figure 7**).

2.16 Maintaining accurate and complete records of the Scottish taxpayer population continues to be the main challenge for HMRC in administering Scottish income tax. HMRC has many information sources for changes of address but relies primarily on taxpayers informing it of such changes on a timely basis, although taxpayers are not legally required to do this. HMRC also obtains address information from other sources such as employers, although it is not mandatory for employers to provide updates when their employees' addresses change.

2.17 Address information must be correct to ensure the right amount of tax is collected from individuals and allocated to the appropriate government. HMRC has several assurance processes in place to maintain the completeness and accuracy of the address data it uses to identify Scottish taxpayers (**Figure 8**) on page 26.

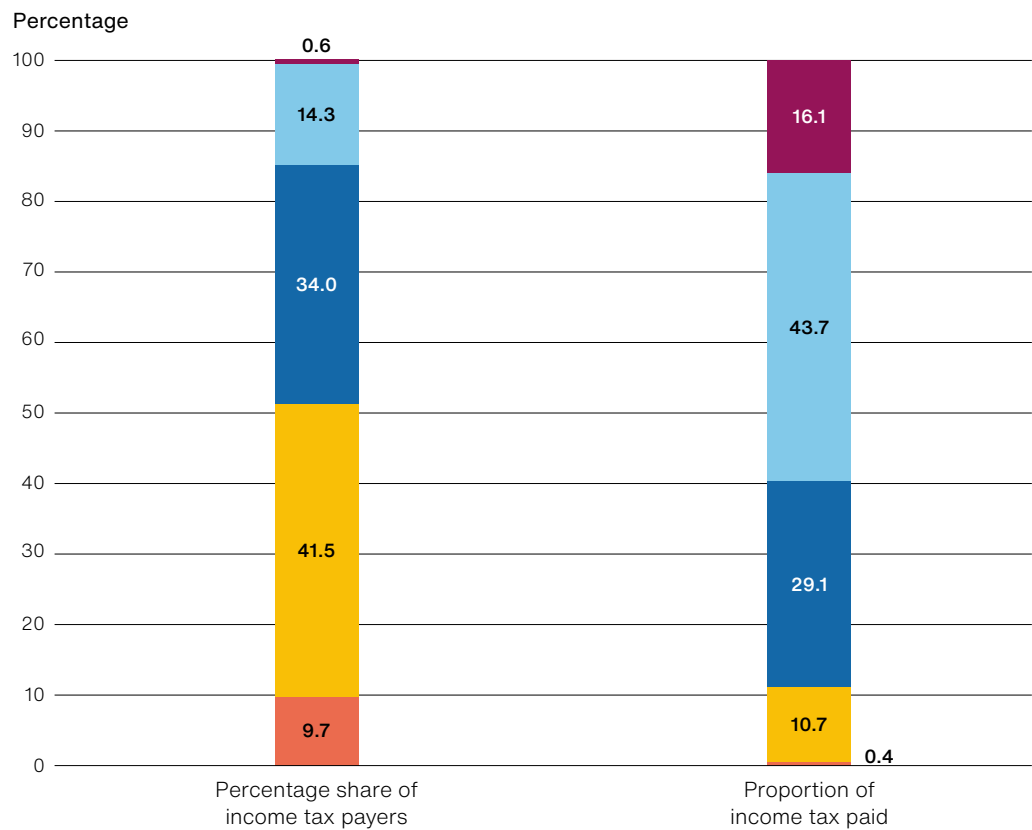
⁶ HM Revenue & Customs, *Scottish Income Tax Outturn Statistics: 2020 to 2021*, July 2022.

⁷ Scottish parliamentarians are also deemed Scottish taxpayers. See paragraph 2.26 for more details.

Figure 7

Proportion of income taxpayers by band and income tax paid by band in Scotland, 2020-21

Higher-rate and top rate income taxpayers accounted for 15% of the population and contributed around 60% of income tax paid



- Top rate
- Higher rate
- Intermediate rate
- Basic rate
- Starter rate

Notes

- 1 2020-21 is the latest year for which data are available.
- 2 Percentages may not sum to 100 due to rounding.

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

Figure 8

Assurance over the Scottish taxpayer population

HM Revenue & Customs (HMRC) carries out several assurance activities to maintain the completeness and accuracy of the Scottish tax base

Assurance activity	Purpose	Results
Controls ensuring Scottish residency is correctly determined using the address held by HMRC		
New postcodes	Comparison of HMRC's list of Scottish postcodes with Office for National Statistics (ONS) data to ensure postcodes are up to date.	Postcode data are received quarterly from the ONS. There were 1,257 new postcodes added in 2021-22.
Address-cleansing	Scans of taxpayer records held by HMRC to identify missing or invalid postcodes which would result in an incorrect residency status being applied.	Scans undertaken in June 2021 identified 16,728 missing postcodes. Of these, 865 cases were updated because they had a record of current employment or pension. The remaining records were not updated because no employment was listed. HMRC also identified 8,760 invalid postcodes and updated 2,166 taxpayer records where there was a record of current employment or pension. ¹
Cross-border postcodes	HMRC's systems flag address changes where new addresses lie in a postcode that crosses the England-Scotland border. HMRC reviews these cases to ensure the correct residency is determined.	This process has been in place since October 2019. In 2021-22, 34 cross-border cases were reviewed, of which five were amended following investigation.
Missing residency flags	Scans to identify Scottish taxpayer records that are not flagged as such in the system.	Scans undertaken during 2021-22 identified 5,786 cases, all of which were updated.
Controls monitoring the operation of Pay As You Earn (PAYE) by employers		
Tax code comparison scans	A comparison between tax codes in PAYE submissions with HMRC's taxpayer record to identify cases where the employer is applying a different tax code to HMRC.	In March 2022 there were 41,182 cases identified where 'S' prefixes were not correctly applied to tax codes. ²
Controls to identify incorrect addresses held by HMRC		
Third-party data comparison	A comparison of taxpayer address records held by HMRC with third-party data sources to identify cases where HMRC records are inconsistent with third-party data. The exercise is HMRC's main source of assurance over the accuracy of its address records.	HMRC and the Scottish Government agreed in October 2020 to run this exercise every two years. The most recent one was performed in April 2021 and compared 5.1 million Scottish address records. HMRC identified 8,347 records where the residency determined from the address held by HMRC did not match the residency suggested by third-party data.
High net worth individuals	HMRC performs checks and procedures to review the movements of high net worth individuals and ensure their addresses are up to date.	

Notes

- Invalid postcodes identified are corrected or manually set as Scottish where the correct postcode cannot be determined from the address.
- Figures are from HMRC's analysis of monthly tax code scans and show the number of tax codes where the Scottish 'S' prefix was not correctly applied, and where the tax code would have otherwise been correct.

Source: National Audit Office summary of HM Revenue & Customs activities

Postcode scans

2.18 HMRC scans taxpayer records to identify missing or invalid postcodes which would result in an incorrect residency status being applied. It investigates and updates identified cases where individuals were either employed or receiving a pension. The most recent scan performed in June 2021 identified 25,488 postcodes either missing or invalid, of which 3,031 were updated. This compares with 61,213 postcodes either missing or invalid in HMRC's previous scan in September 2020, of which 9,429 were subsequently updated. Those cases not updated are identified as dormant because they have no current taxable income. Numbers of postcodes either missing or invalid represent 1% of the 2.5 million Scottish income taxpayer population, compared with 2% in September 2020.

The administration of Scottish tax codes

2.19 Where an employer does not apply the 'S' prefix to an employee's tax code, they will deduct tax at the UK rate. HMRC reconciles what each taxpayer has paid in tax against what it thinks they should have paid at the end of the tax year. HMRC then uses this finalised information and the residency status held on its systems to calculate the tax liability each taxpayer should pay. The outturn for Scotland is, therefore, unaffected where the 'S' prefix in an individual's tax code is not correctly applied by an employer.

2.20 Using a tax code without the 'S' prefix could result in Scottish taxpayers either under- or over-paying tax during the tax year. In this situation, taxpayers may have to pay additional amounts in future years to offset an underpayment or await a refund from HMRC for any overpayments. HMRC does not collate the number of reconciliations for Scottish taxpayers where the amount of tax collected was different from the amount HMRC calculated should have been paid.

2.21 Each month, HMRC compares tax codes in PAYE submissions with its own taxpayer record to identify cases where employers are using a different tax code. The number of cases where the correct 'S' prefix was not being operated varies across the year. In March 2021, HMRC identified 39,364 Scottish taxpayer records (1.2% of cases at that time) where employers were not operating a tax code with an 'S' prefix. In March 2022, there were 41,182 cases (1.1% of cases). We noted in previous reports that HMRC has not set a target for how low the number of missing 'S' prefixes would be before it considers that its compliance activity has been successful.

2.22 When HMRC identifies an employer is not using the correct tax code, it issues a P6 notification to the employer asking them to update the employee's tax code. HMRC identifies employers making persistent errors and works with them to implement the correct tax code. HMRC told us that the number of employers that repeatedly use the incorrect tax code is very low and so it does not routinely track this information.

Third party-data exercise

2.23 HMRC periodically compares the Scottish taxpayer address records it holds with third-party data to identify differences. This comparison is HMRC's main source of assurance over its address information and it previously agreed with the Scottish Government to run the exercise every two years.

2.24 In April 2021, 5.1 million Scottish address records held by HMRC were compared with third-party data, showing that:

- 3.7 million records (72.2% of records analysed) held by HMRC were successfully matched to third-party data with a Scottish address. This is a decrease from 78.7% in the previous third-party data exercise in 2019;
- 8,347 records (0.2% of records analysed) were identified where the residency determined from the address held by HMRC did not match the residency suggested by third-party data; and
- the residency status of taxpayers for 1.4 million records (27.7% of records analysed) could not be corroborated by comparison with the third-party data. HMRC reviewed these records against other internal data sources to gain assurance over the accuracy of the addresses held.⁸

2.25 HMRC wrote to most of the taxpayers where the details of residence held by HMRC did not match that suggested by third-party address data. Letters asked taxpayers to check that the address held by HMRC was up to date. There are limits to how effective this exercise can be. Due to data protection legislation, HMRC can only write to each taxpayer at the address it holds on its system, and not any alternative address indicated by the third party-data exercise. HMRC followed up a sample of 100 Scottish taxpayers who received a letter in 2021. It found 33 had subsequently updated their address details with HMRC. It also found 30% of all Scottish taxpayers receiving a letter had also received a letter during the previous third party-data exercise in 2019.

⁸ Approximately 142,000 records were discounted from any analysis as the individuals concerned were under the age of 18, deceased, indicated as living abroad or were duplicate records.

Scottish parliamentarians

2.26 Scottish parliamentarians are automatically deemed as Scottish taxpayers in any tax year they are in office. This applies to the 129 elected members of the Scottish Parliament (MSPs) and the 59 members of Parliament in Westminster representing a constituency in Scotland. Records for Scottish parliamentarians are not processed using normal business rules. HMRC previously used a manual process to identify these records and ensure they were recorded as Scottish taxpayers regardless of residency. HMRC required employers or parliamentarians themselves to provide the required information to HMRC annually. HMRC introduced system changes designed to remove the need to annually update parliamentarians' records in August 2020. HMRC told us that it did not identify any issues in relation to Scottish parliamentarians being recorded as Scottish taxpayers during 2021-22.

Compliance risk assessment and planning

2.27 HMRC applies the same risk-based compliance approach to collect income tax in Scotland as it does in the rest of the UK. This approach involves:

- **promoting** compliance by designing processes to encourage and help customers get things right first time;
- **preventing** non-compliance through process design and customer insight and providing an opportunity to correct mistakes; and
- **responding**, investigating and correcting compliance risks using tailored activity when intervention is needed.

2.28 As part of its Service Level Agreement with the Scottish Government, HMRC produces an annual Scottish Strategic Picture of Risk (SPR) to assess and plan for compliance risks applicable to Scotland. For the Scottish SPR, HMRC considers key compliance risks at the overall UK level and applies a value to represent the Scottish proportion of these risks. HMRC does not vary the size of this proportion for each risk; instead it is calculated in line with Scotland's share of UK income tax in the Scottish Income Tax Outturn Statistics. As with previous years, HMRC has not identified any significant risks specific to Scotland and considers the main risks to Scottish income tax are the same as for the whole of the UK. These risks include:

- evasion, where individuals or businesses deliberately omit, conceal or misrepresent information to reduce their tax liabilities;
- the hidden economy, where taxable income is not declared or where declared income is deliberately understated; and
- tax avoidance, where tax rules are exploited to gain a tax advantage that Parliament never intended.

2.29 There is a risk that HMRC's current assessment that compliance risk in Scotland is consistent with the rest of the UK may not be sustainable in the longer term, particularly if further divergence occurs in tax policy between Scotland and the rest of the UK. HMRC told us that it monitors risks specific to Scottish income tax and would include these in future SPRs if it deemed appropriate. It gains assurance that its assessment of Scottish-specific risk is low through its bi-annual address assurance exercises and tracking the number of compliance cases it has identified as relating to the residency status as a Scottish taxpayer. It told us that a factor in its assessment was the level of divergence between Scottish income tax and the rest of the UK. HMRC does not test its assumption that non-compliance in Scotland is the same as the rest of the UK because of the methodological challenges and costs involved.

2.30 Under the Memorandum of Understanding between HMRC and the Scottish Government the Scottish Government can propose further compliance activity which HMRC will carry out if it agrees it is feasible, would reduce revenue risk and improve compliance. HMRC would charge the costs of this further activity to the Scottish Government. The Scottish income tax compliance plan for 2021-22 was agreed by HMRC and the Scottish Government in July 2021. The Scottish Government did not request any specific compliance activity to be undertaken in 2021-22, in addition to the work undertaken as part of HMRC's UK-wide compliance approach. The Scottish Government told us it obtained data from HMRC on Scottish incorporated companies and cross-border home ownership to give it further assurance on HMRC's compliance activity.

2.31 HMRC measures the effectiveness of its enforcement and compliance activities through compliance yield, its estimate of the additional revenues it considers it has generated and the losses it has prevented. HMRC estimates a compliance yield of £280 million in 2020-21 for Scotland's share of the risks in the SPR. It also estimates that Scotland's share of net losses from these risks was £970 million.⁹ HMRC calculates these figures as a proportion of the equivalent UK figure, rather than using Scotland-specific data to quantify the risks. HMRC does not consider or report on geographical variation between Scotland and the rest of the UK when assessing compliance risk or the relative success of compliance activity.

2.32 The tax gap is the difference between the amount of tax that should be paid and what is actually paid. HMRC does not currently produce a Scotland-specific tax gap. HMRC's view remains that calculating a Scotland-specific tax gap would be difficult for methodological reasons, including the increased burden on taxpayers who would be selected for further enquiry, the additional HMRC resource which would need to be deployed, and the loss of Exchequer revenue associated with redeployment of compliance staff away from yield-bearing work.¹⁰

2.33 HMRC has limited information on total compliance activity undertaken in Scotland. Its compliance system allows HMRC to raise a flag where potential manipulation of residency status has been identified. We understand there are currently no such flags on the compliance system. It told us that information about numbers of active compliance cases relating to Scottish taxpayers for reasons not related to their status as a Scottish taxpayer requires interrogation of separate information systems. Unlike the income tax system, which can flag Scottish residents, HMRC's compliance management information system cannot readily identify people living in Scotland and information must be compared with other data to provide numbers on the extent of Scottish non-compliance in total.

Impact of COVID-19 on HMRC's compliance activity and debt management

2.34 The impact of the COVID-19 pandemic, and HMRC's response to it, affected its compliance activity in 2021-22 and reduced the level of tax receipts collected through it. The pandemic limited HMRC's ability to visit taxpayers to carry out its compliance investigations. In addition, some staff were reallocated from compliance work to support other COVID-19 measures during the year. Across the UK, the number of compliance cases opened and closed in 2021-22 was higher than in 2020-21 but 27% lower than in 2019-20 before the pandemic.

⁹ This relates to the latest data available for net losses, covering 2019-20. This means the impact of the COVID-19 pandemic on net losses will only begin to show in next year's SPR.

¹⁰ Letter from HMRC to the Public Audit and Post-legislative Scrutiny Committee of the Scottish Parliament, on 12 March 2021, available at: https://archive2021.parliament.scot/S5_Public_Audit/General%20Documents/2103112_Ruth_Stancier_to_PAPLS_Committee.pdf.

2.35 HMRC's yield from its tax compliance activities was £30.8 billion in 2021-22, up 1.1% compared with 2020-21 but lower than the £36.9 billion reported in 2019-20. Our recent report *Managing tax compliance following the pandemic* found that HMRC's compliance work had raised around £9 billion less revenue since the pandemic began, compared with historical levels. We concluded that it would take some time to understand fully whether the pandemic has affected tax compliance, with swift action likely to be needed to prioritise efforts and stem potential losses.¹¹

2.36 HMRC's management of tax debt affects how much income tax that is initially unpaid is subsequently collected across the UK, including in Scotland. HMRC's debt balance is affected by external factors that have an impact on taxpayers' ability to pay their tax liabilities, including current inflationary pressures and increases in the cost of living. At 31 March 2022, total tax debt for the UK was £41.6 billion, 28% (£15.9 billion) less than the debt reported at 31 March 2021 but 86% (£19.2 billion) higher than the level of debt reported at 31 March 2020, before the impact of the pandemic. HMRC expects the level of tax debt will fall more slowly than it initially anticipated. Our report *Managing tax debt through the pandemic* provides further detail on how HMRC changed its debt management work in response to the pandemic.¹²

2.37 HMRC estimated total tax debt in respect of Scottish taxpayers to be £2.0 billion as at 31 December 2021, 5.7% of UK tax debt at that time.¹³ Some £0.9 billion of this was attributed to debts from PAYE and Self Assessment income tax. The estimate was calculated to answer a question from the Scottish Public Audit Committee, with no equivalent figure being available at 31 March 2022.

Divergence between Scottish and rest-of-UK income tax rates

2.38 The amount of income tax paid in Scotland diverges the most in percentage terms from the rest of the UK for those earning around £50,000, with a Scottish taxpayer earning around that amount paying 20% more than a taxpayer elsewhere in the UK (**Figure 9**). This divergence means there is a potential risk that taxpayers subject to higher Scottish rates may seek to manipulate their residency status to reduce their tax liability. This could include failing to notify HMRC of address changes or deliberately manipulating address information. HMRC considers that the risk of these behaviours is very low compared with the overall risk of non-compliance across the UK, such as efforts to avoid or reduce liabilities altogether.

2.39 In 2021-22, the divergence between the tax regimes in Scotland and the rest of the UK remained broadly the same as in 2020-21, although it reduced slightly for those earning around £50,000.

¹¹ Comptroller and Auditor General, *Managing tax compliance following the pandemic*, Session 2022-23, HC 957, National Audit Office, December 2022.

¹² Comptroller and Auditor General, *Managing tax debt through the pandemic*, Session 2021-22, HC 799, National Audit Office, November 2021.

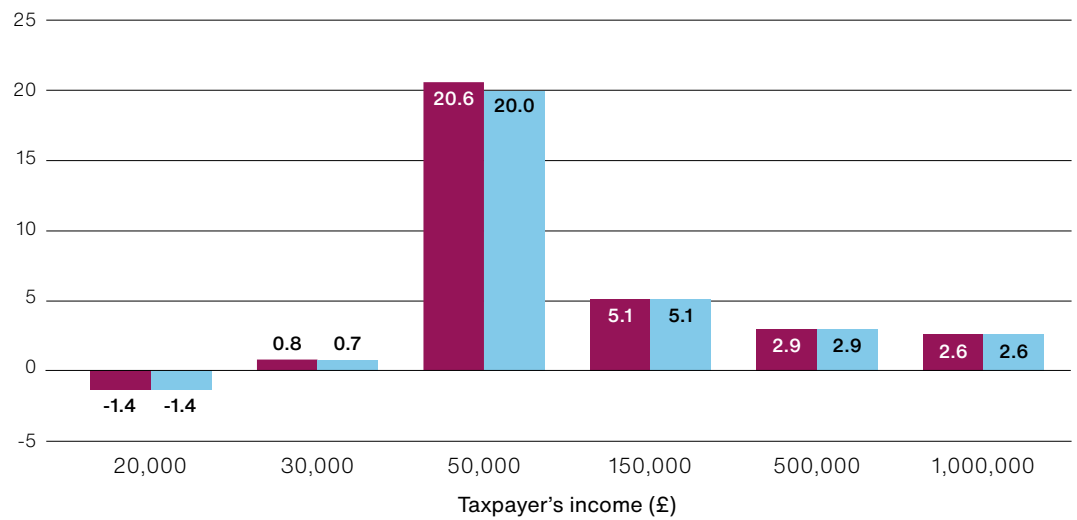
¹³ Figures provided by HMRC to the Convener of the Scottish Public Audit Committee in June 2022. Figures do not sum to the total debt balance of £39.5 billion at that time because they exclude non-UK debts where the country cannot be identified. We have not audited these figures.

Figure 9

Differences in the tax liability between taxpayers in Scotland and in the rest of the UK

Compared with 2020-21, income tax liabilities in Scotland have remained broadly the same, with the overall divergence from the rest of the UK remaining greatest for taxpayers earning around £50,000

Percentage difference in tax paid (%)



■ 2020-21

■ 2021-22

Income (£)	2021-22				2020-21
	UK income tax (£)	Scottish income tax (£)	Difference compared with UK income tax (£)	Difference compared with UK income tax (%)	Difference compared with UK income tax (%)
20,000	1,486	1,465	-21	-1.4	-1.4
30,000	3,486	3,512	26	0.7	0.8
50,000	7,486	8,980	1,494	20.0	20.6
150,000	52,460	55,133	2,673	5.1	5.1
500,000	209,960	216,133	6,173	2.9	2.9
1,000,000	434,960	446,133	11,173	2.6	2.6

Note

1 These figures assume a taxpayer has a full personal allowance and only had non-savings, non-dividend income during the year. It does not include any other allowance or reliefs.

Source: National Audit Office analysis of income tax rates and bands in Scotland and the UK for 2020-21 and 2021-22

2.40 In December 2022, the Scottish Government announced that the top rate of income tax will increase from 46% to 47% and that the higher rate of income tax will increase from 41% to 42%. This will come into effect on 6 April 2023 to cover the 2023-24 tax year. The level at which taxpayers will pay the top rate of income tax will reduce from £150,000 to £125,140 for taxpayers in both Scotland and the rest of the UK. We will consider the impact of these changes in future reports.

2.41 HMRC has not identified any significant or widespread instances of taxpayers changing their address to obtain a tax advantage. HMRC has several ways to identify compliance risk:

- HMRC periodically compares its address records with those of third-party data sources. If the number of discrepancies increase, this may indicate taxpayers are not updating HMRC with address changes, either through error or deliberately.
- Each month, HMRC compares PAYE submissions with its own records to identify cases where employers are not correctly applying 'S' prefixes to tax codes for Scottish residents. If the number of incorrect 'S' codes varies from HMRC's expectations, this could suggest wider compliance issues.
- HMRC monitors cross-border migration trends. HMRC has reviewed taxpayers who have moved from Scotland to England since 2017-18 and found 1.6% of cross-border movements could not be fully reconciled to Land Registry data and therefore merited further scrutiny.

2.42 HMRC began work in 2020 looking into Scottish taxpayer liabilities and behaviour in response to Scottish income tax changes introduced in 2018-19. The analysis from this work was published in December 2021 and showed some limited evidence of Scottish taxpayers lowering their taxable income in response to increasing tax rates. HMRC's analysis covered actions taken by taxpayers to lower their taxable income such as tax avoidance activities, changing the number of hours worked, or deciding whether to invest time in a personal business. It only looked at taxpayers who paid Scottish income tax in all three years it reviewed and so does not cover actions which removed the taxpayer from the workforce entirely such as retirement or migration.

2.43 HMRC found that generally taxpayers on higher incomes decreased their declared income by more than those on lower incomes. For taxpayers earning more than £150,000, HMRC estimated that a 1% reduction in the proportion of income they retain after tax leads to a reduction between 0.52% and 0.77% in the level of income they declare to HMRC.¹⁴ HMRC has not undertaken any specific actions in response to this research given its overall assessment of risk in Scottish income tax. It told us that while the research found that increasing tax rates indicated increased risk of behavioural change it did not show that the behaviour change would be non-compliant.

2.44 In 2022 HMRC began work with the Scottish and Welsh governments to analyse cross-border migration and taxpayer characteristics over time. HMRC told us that the dataset from this work will enable it to analyse cross-border migration in response to any income tax changes between devolved administrations and the rest of the UK. HMRC has established a working group to oversee the design of the dataset and agree what analysis it will complete, which includes representatives from the devolved administrations. The work is being funded by the UK government, Scottish Government and Welsh Government. It expects to produce its first dataset by the time it publishes the Scottish Income Tax Outturn Statistics for 2021-22.

2.45 Having completed our additional work on devolved tax issues, we are satisfied HMRC has adequate rules and procedures in place to assess and collect Scottish income tax and that these are being complied with.

¹⁴ HM Revenue & Customs, *Estimating Scottish taxpayer behaviour in response to Scottish Income Tax changes introduced in 2018 to 2019*, December 2021, available at: www.gov.uk/government/publications/estimating-scottish-taxpayer-behaviour-in-response-to-scottish-income-tax-changes-introduced-in-2018-to-2019.

Part Three

Costs

3.1 This part considers the administrative costs of Scottish income tax and whether they are reasonable.

3.2 Under the Service Level Agreement between HM Revenue & Customs (HMRC) and the Scottish Government, the Scottish Government must reimburse HMRC for net additional costs incurred through administering Scottish income tax powers.

3.3 A supporting framework sets out the principles for identifying net additional costs. HMRC recharges the Scottish Government only for costs that specifically relate to administering devolved Scottish income tax powers, not for the costs of administering the overall income tax system in Scotland.

Costs incurred in 2021-22

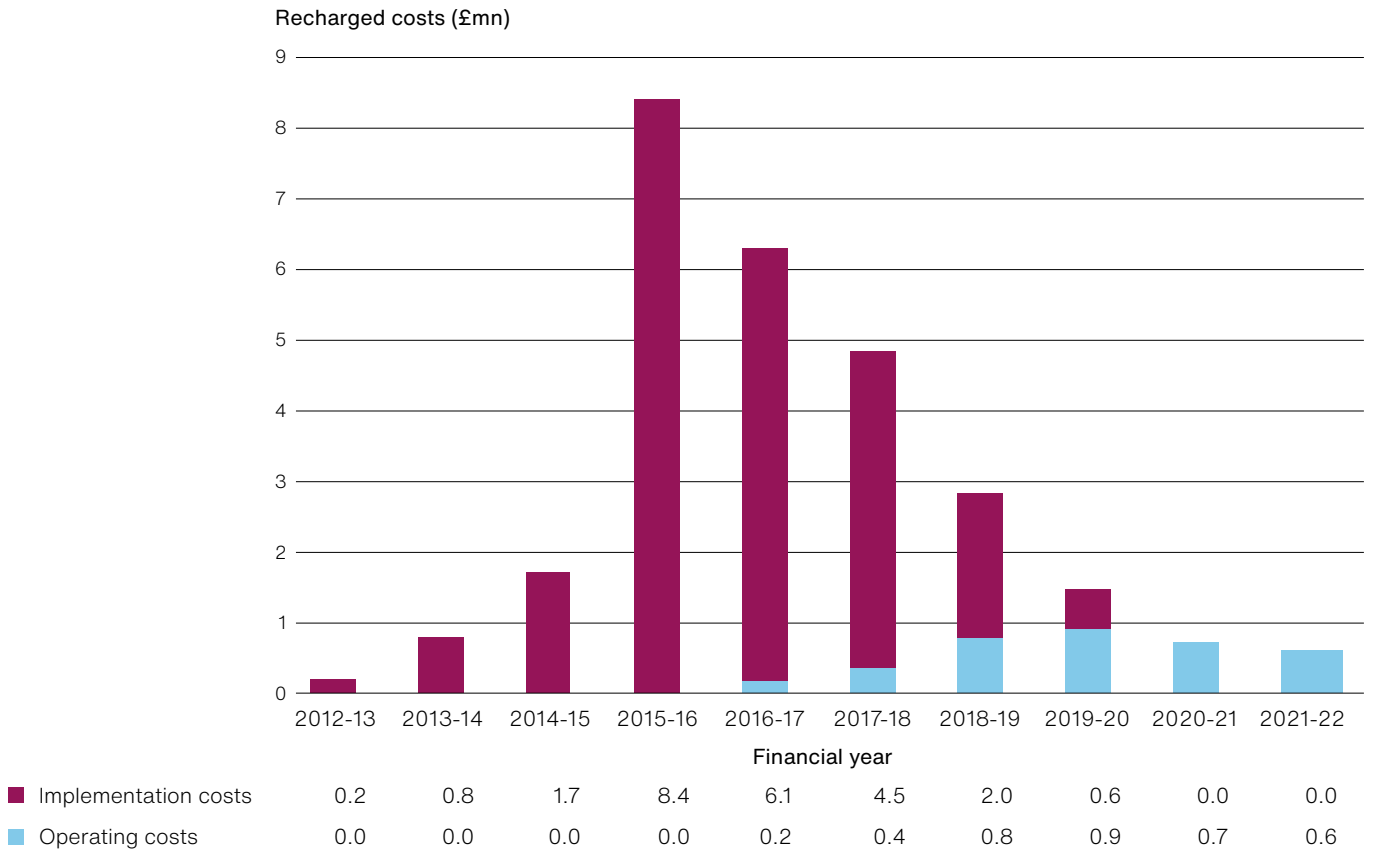
3.4 HMRC invoiced the Scottish Government for £0.6 million of costs relating to the administration of Scottish income tax in 2021-22. This was a £0.2 million underspend against the budget of £0.8 million, and £0.1 million lower than the £0.7 million HMRC recharged in 2020-21. Reasons for the underspend against the budget included less time spent on Scottish income tax by HMRC staff than planned, delays in recruitment and savings in relation to Scottish income tax processes becoming business-as-usual. There have been no significant changes to the recharging process in 2021-22. HMRC completed the implementation of the Scottish Income Tax Project in 2019-20 and so 2021-22 is the second year in which expenditure relates entirely to operating costs (**Figure 10**).

3.5 We examined HMRC's method for estimating the costs to collect and administer Scottish income tax for the year ended 31 March 2022. Based on our audit work, we concluded that the amount paid by the Scottish Government was accurate and fair in the context of the agreement between HMRC and the Scottish Government.

Figure 10

Actual spending on Scottish income tax projects from 2012-13 to 2021-22

Spending during the 2020-21 and 2021-22 financial years relates solely to operating costs

**Note**

1 Figures may not sum due to rounding.

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

Appendix One

Our evidence base

1 Section 80HA of the Scotland Act 1998, as amended by the Finance Act 2014, requires the Comptroller and Auditor General (C&AG) to prepare a report for each financial year on:

- the adequacy of any of HM Revenue & Customs' (HMRC's) rules and procedures put in place, in consequence of the Scottish rate provisions, for the purpose of ensuring the proper assessment and collection of income tax charged at rates determined under those provisions;
- whether these rules and procedures are being complied with;
- the correctness of the sums brought to account by HMRC which relate to income tax which is attributable to a Scottish rate resolution; and
- the accuracy and fairness of the amounts which are reimbursed to HMRC as administrative expenses.

2 To reach the conclusions of this report relating to the rules and procedures operated by HMRC, we drew directly from our statutory audit work on HMRC's Annual Report and Accounts, including the C&AG's report on HMRC's controls for the proper assessment, collection and allocation of tax under Section 2 of the Exchequer and Audit Departments Act 1921. We also completed specific audit procedures over controls relevant to administering devolved taxes.

Financial audit

3 We audited the data, methodologies, assumptions and mechanics of the calculation for the revenue outturn for 2020-21 and the revenue estimate for 2021-22, which are described in this report. For the estimate, and where appropriate for the outturn, this work was planned and completed by applying principles set out in International Standards on Auditing (UK) 540 Auditing Accounting Estimates and Related Disclosures, to design audit procedures relevant to the nature of the estimates and to a sufficient level of precision.

4 In relation to administration costs, our conclusion on the accuracy and fairness of the costs HMRC charged to the Scottish Government is based upon evaluating costs against the details of the Service Level Agreement and supporting framework for costs agreed between both parties. HMRC estimated some of the incurred costs from available data on customer contacts and staff time. During the audit, we saw evidence that both parties regularly discuss and review cost budgets and forecasts as well as agreeing any amounts to be invoiced and paid.

5 All of these audit procedures were planned, performed and reviewed in accordance with our internal quality control procedures for financial audit.

6 We completed our financial audit fieldwork between April 2022 and July 2022.

Document review

7 To evaluate HMRC's approach to compliance risk, we reviewed published and unpublished HMRC documents about Scottish income tax including project documentation, risk and compliance documentation, and details of key assurance work performed by HMRC.

8 Our review was carried out between October 2022 and December 2022.

Interviews with departmental officials

9 We carried out four interviews with officials from HMRC, selected to participate because of their job role and their relevance to the audit. This included staff responsible for (or involved in) devolved tax policy and compliance.

10 We also spoke to the Scottish Government and Audit Scotland to inform our risk assessment and planning for this report.

11 Fieldwork took place between October 2022 and November 2022. Interviews were carried out online, typically lasted one hour and notes were taken.

Third-party data exercise teach-in

12 To inform our understanding of HMRC's processes to gain assurance over the Scottish taxpayer population we attended a teach-in run by HMRC in November 2022 covering the third-party data exercise which it performs using a third-party supplier.

Quantitative analysis

13 We analysed financial data from HMRC on Scottish income tax revenue, HMRC's estimate of Scottish income tax revenue and the administrative costs of Scottish income tax.

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Public Audit Committee

9 February 2023

Administration of Scottish Income Tax 2021/22

Briefing Paper by the Auditor General for Scotland

1. The Auditor General's report the Administration of Scottish Income Tax 2021/22 was published on 12 January 2023.
2. From 2017/18 onwards, Scottish income tax, collected by HM Revenue and Customs (HMRC) in Scotland is paid to the Scottish Government. HMRC's accounts are audited by the National Audit Office (NAO) and the Comptroller and Auditor General (C&AG) issued his opinion on the 2021/22 HMRC Accounts in July 2022. The C&AG is also required to report to the Scottish Parliament on HMRC's administration of Scottish income tax by 31 January of the financial year after the one to which the report relates.
3. Since 2014, in response to a recommendation by the predecessor Public Audit Committee, the Auditor General for Scotland has produced an annual report to provide additional assurance on the NAO's audit work on Scottish income tax. This is the eighth annual report.
4. The Public Audit Committee's report [Framework for auditing the Scottish rate of income tax](#) set out what audit information the Scottish Parliament can expect to receive to enable it to undertake its accountability role in relation to Scottish income tax. In relation to Audit Scotland, the Committee recommended that:
 - Audit Scotland provides additional assurance on the NAO's audit of HMRC and Scottish income tax. The Committee also recommended that Audit Scotland works with the NAO on its future priorities for any performance audit work on the Scottish income tax.
 - the joint working relationship between the Comptroller and Auditor General and the Auditor General for Scotland should be set out in a memorandum of understanding.
 - Audit Scotland reports annually on its assurance work in relation to Scottish income tax.
5. Audit Scotland's review was carried out in accordance with the memorandum of understanding agreed between myself and the Comptroller and Auditor General. This describes our respective powers and responsibilities and sets out a framework for collaborative working.
6. My report also considers the impact of tax outturns on the Scottish Government's budget. The difference between actual UK and Scottish tax outturns for 2020/21 and the amounts forecasted at the time is adjusted through the 2023/24 budget. This is known as a budget reconciliation. The reconciliation for the 2020/21 outturns results in an increase to the 2023/24 budget of £50 million. This is the first time there has been a positive income tax reconciliation to the Scottish budget.
7. Key messages from the report are:
 - The National Audit Office's approach to providing assurance over Scottish income tax is reasonable and covers the key audit risks.

- The Scottish income tax outturn for 2020/21 is £11.948 billion. The economic effects of the Covid-19 pandemic reduced the amount of Scottish income tax collected in this period. Because equivalent tax receipts in the rest of the UK were also affected, the net reconciliation of 2020/21 income tax will increase the 2023/24 Scottish budget by £50 million. This is the first time there has been a positive income tax reconciliation to the Scottish budget.
- HMRC's provisional estimate of Scottish income tax for 2021/22 is £13.295 billion. The provisional estimate is provided for financial reporting purposes and does not affect the Scottish budget. The Scottish Government and HMRC should keep methodologies under review as more data becomes available to ensure provisional estimates are as accurate as possible.
- Given ongoing economic uncertainty and volatility and separate Scottish and UK income tax policies, the Scottish Government and HMRC should keep governance and assurance arrangements under continual review.
- There has been a decrease in the percentage of Scottish taxpayer records that could be corroborated by HMRC to third-party data to confirm residency status. Where addresses were not able to be matched, they were instead checked against internal HMRC records, such as information from self-assessments and information from employers. The Scottish Government and HMRC should consider if more frequent checks or further actions are required to provide further assurance over the accuracy of HMRC's address records.
- HMRC applies the same risk-based compliance approach to collect income tax in Scotland as it does in the rest of the UK. This is based on its assessment that compliance risk in Scotland is consistent with the rest of the UK. The Scottish Government should regularly consider the costs and benefits of commissioning further compliance activity in Scotland.
- HMRC and the Scottish Government have recently published analysis of taxpayer behaviour which showed some limited evidence of Scottish taxpayers lowering their taxable income in response to increasing tax rates. HMRC is working with the Scottish Government to produce a dataset tracking the behaviour of taxpayers over time in response to any income tax changes between Scotland and the rest of the UK. The first output from this work is expected in summer 2023. Obtaining better quality data about taxpayer behaviour will help inform future tax policy decisions.

Administration of Scottish income tax 2021/22



AUDITOR GENERAL 

Prepared by Audit Scotland
January 2023

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Introduction

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

2. HMRC's accounts are audited by the National Audit Office (NAO) and the Comptroller and Auditor General (C&AG) issued his opinion on the 2021/22 HMRC Accounts in July 2022. The C&AG is also required to report to the Scottish Parliament on HMRC's administration of Scottish income tax by 31 January of the financial year after the one to which the report relates.¹

3. In 2014, the predecessor Public Audit Committee of the Scottish Parliament recommended that I should provide additional assurance on the NAO's audit work on Scottish income tax.² I make this report to the Public Audit Committee in response to that recommendation.

Key messages

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

¹ Scotland Act 1998, section 80HA as amended by the Finance Act 2014, section 297.

² 1st Report, 2014 (Session 4): Framework for auditing the Scottish rate of income tax, Public Audit Committee, 2014.

- Given ongoing economic uncertainty and volatility and separate Scottish and UK income tax policies, the Scottish Government and HMRC should keep governance and assurance arrangements under continual review.
- There has been a decrease in the percentage of Scottish taxpayer records that could be corroborated by HMRC to third-party data to confirm residency status. Where addresses were not able to be matched, they were instead checked against internal HMRC records, such as information from self assessments and information from employers. The Scottish Government and HMRC should consider if more frequent checks or further actions are required to provide further assurance over the accuracy of HMRC's address records.
- HMRC applies the same risk-based compliance approach to collect income tax in Scotland as it does in the rest of the UK. This is based on its assessment that compliance risk in Scotland is consistent with the rest of the UK. The Scottish Government should regularly consider the costs and benefits of commissioning further compliance activity in Scotland.
- HMRC and the Scottish Government have recently published analysis of taxpayer behaviour which showed some limited evidence of Scottish taxpayers lowering their taxable income in response to increasing tax rates. HMRC is working with the Scottish Government to produce a dataset tracking the behaviour of taxpayers over time in response to any income tax changes between Scotland and the rest of the UK. The first output from this work is expected in summer 2023. Obtaining better quality data about taxpayer behaviour will help inform future tax policy decisions.

Background

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

- reimbursing HMRC for the cost of implementing Scottish income tax
- ensuring that the cost of implementing Scottish income tax represents value for money
- seeking assurances that the system collects the correct amount of tax
- discussing and agreeing with HMRC aspects of the approach to the administration of Scottish income tax as set out in a service level agreement.

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

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

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

Audit and assurance

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

- HMRC's calculation of the 2020/21 income tax revenue attributable to Scotland and provides assurance on the correctness of the amounts brought to account
- HMRC's estimation of the 2021/22 income tax revenue attributable to Scotland and his view on the methodology used to estimate the amount
- key controls operated by HMRC to assess and collect Scottish income tax
- HMRC's approach to assessing and mitigating the risk of non-compliance with Scottish tax requirements
- the cost of administering Scottish income tax and provides assurance on whether the amounts are accurate and fair in the context of the costs incurred by HMRC.

9. Audit Scotland considered:

- the NAO's approach to identifying the key risks to the successful administration of Scottish income tax
- the NAO's audit working files, with focus on the audit evidence underpinning the key findings and conclusions in its report

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

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

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

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

Correctness of the sums brought to account

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

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

2020/21 final outturn

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

15. The 2020/21 outturn calculation of £11.948 billion is largely based on established tax liabilities, after the tax owed has been finalised and the taxpayer records have been reconciled. The remainder is based on estimated liabilities; including, HMRC's estimate of PAYE tax liabilities that have not yet been finalised and where tax liabilities are expected from future self-assessment returns or compliance activity. The calculated estimate is required because the income tax liability data is not available to identify the Scottish share of individual income tax liabilities, reliefs or other adjustments at the point the outturn is calculated.

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

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

The impact of Covid-19 on 2020/21 outturns

17. Lockdown measures in Scotland began on 23 March 2020, shortly before the beginning of the 2020/21 tax year. The Scottish Fiscal Commission has reported⁵ that the economic effects of the pandemic reduced the amount of income tax collected in this period, noting that:

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

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

2021/22 provisional estimate

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

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

21. The C&AG concludes that HMRC’s approach is reasonable, but outlines the continuing limitations described in [previous reports](#) in relation to using SPI data. The C&AG also concludes that the impact of other external factors such as Covid-19 and the Ukraine conflict on both the economy and individual taxpayers increases the level of uncertainty in HMRC’s estimate of Scottish income tax revenue.

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

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

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

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

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

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

25. The administration of Scottish income tax is governed by a service level agreement (SLA) between HMRC and the Scottish Government.⁶ This is updated every year to reflect HMRC's planned work. The SLA sets out the requirements and performance measures for the operation of Scottish income tax. HMRC shares the results of assurance exercises and compliance activities with the Scottish Government throughout the year and publishes an annual summary of its performance against the requirements.⁷

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

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

Scottish Tax Base

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

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

⁶ HM Revenue & Customs, Service level agreement for operation of Scottish Income Tax by HMRC, 3 November 2021.

⁷ Scottish Income Tax HMRC Annual Report 2021, HMRC, December 2021.

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

30. HMRC conducted a third-party data check in April 2021, which was previously completed in November 2019. This involves comparing taxpayer address records held by HMRC with third-party data sources (including credit reference agencies and the electoral roll) to identify cases where HMRC records are inconsistent with third-party data.

31. Not all taxpayer records could be corroborated against third party information. Where this was the case, the addresses were instead checked against internal HMRC records, such as information from self assessments and information from employers. In the case of a mismatch, HMRC wrote to the address it held in its records, asking the taxpayer to confirm their address.

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

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

Compliance risks

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

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

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

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

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

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

Taxpayer behaviour

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

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

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

The accuracy and fairness of the administrative expenses

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

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

Impact of tax outturns on the Scottish Budget

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

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

Exhibit 1

The block grant is adjusted for NSND Scottish income tax



Source: Audit Scotland

47. 2020/21 budget figures for Scottish income tax were based on independent forecasts prepared by the Scottish Fiscal Commission (SFC) and the Office for Budget Responsibility (OBR). A budget adjustment (or ‘reconciliation’) is made in later years once outturn data is known.

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

Exhibit 2

How the Scottish income tax outturn relates to the 2023/24 budget reconciliation

£ million	BGA – reflecting income tax foregone by HM Treasury	Revenue from NSND Scottish income tax	Net effect on budget
Forecasts used for the 2020/21 budget	-12,319	12,365	46
Final outturn	-11,852	11,948	96
Reconciliation required through the 2023/24 budget			50

Source: Audit Scotland, based on [Scotland's Economic and Fiscal Forecasts](#), Scottish Fiscal Commission, December 2022

Administration of Scottish income tax 2021/22

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