Office for **Budget Responsibility**

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Rt Hon Andrew Tyrie MP
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Treasury Select Committee
House of Commons
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Dear Andrew

**MAKING TAX DIGITAL**

When we gave evidence to the committee on 13 March, you requested further information on the policy costing we certified for HMRC's 'Making tax digital' programme and how it has been factored into our forecasts.

**The policy and its delivery**

At Budget 2015, the Government signalled its intention to update the way in which HMRC interacts with taxpayers by digitising much of the tax system over the course of the current Parliament and beyond. One aspect of this was its plan for 'making tax digital' for small businesses by introducing digital record-keeping, using software, apps and quarterly reporting.

The original measure required small businesses, self-employed people and landlords to start using the new digital service from three different points:

- April 2018 if they have profits chargeable to income tax and pay Class 4 NICs and their turnovers are in excess of £10,000. These are collected through self-assessment (SA) payments;
- April 2019 if they are registered for and pay VAT; and
- April 2020 if they pay corporation tax (CT).

At Autumn Statement 2015, we scrutinised the fiscal impact of digital record-keeping and quarterly reporting, and certified the Government's costing as reasonable and central. (We discussed the rest of the package, but the detail of the other elements was not sufficiently firm for us to certify any costings.)

At the time, we paid close attention to the amount of contingency built into the delivery plan and we have reviewed the measure at each Budget and Autumn Statement since it was announced. The four-month delay in HMRC issuing a consultation last year, as a result of the EU referendum result, did absorb some of the contingency, but we have been reassured that delivery for the SA element remains on track for an April 2018 launch.

At Budget 2017, the Government announced two changes to the original policy. As part of its consultation response it has decided that businesses currently using spreadsheets to record transactions will be able to continue to do so, but they must ensure that the spreadsheets meet the necessary requirements of 'making tax digital'. The second change is a one-year delay to the implementation of the income tax self-assessment element for businesses and landlords with a turnover below the VAT threshold.

**The costing**

The scrutiny of policy costings is an iterative process: we are presented with an initial estimate, which we discuss with the relevant department and the Treasury, suggesting changes until we are happy to certify it as reasonable and central. For more complex costings, there are often multiple stages before we are prepared to certify them. This was the case with 'making tax digital'.

When presenting a costing for a tax measure, we generally ask HMRC to set out the policy background and then identify the tax base – the monetary value of the financial stream or asset on which the tax is levied. The next step is a static costing – the estimated fiscal impact that the measure would have in the absence of any behavioural response. We then consider how behaviour might respond and how the costing should be adjusted to account for this.

The element of 'making tax digital' for which we certified the costing at Autumn Statement 2015 is not a conventional tax measure, of the type that broadens or narrows an intended tax base or increases or reduces the rate of tax levied on that base. Rather it was designed to reduce taxpayer error and bring the amount of tax paid closer to that intended under the existing tax base and rate structure. But the costing follows similar principles.

The first step was to estimate the amount of tax lost through error and failure to take reasonable care prior to the measure. At the time of the original costing (November 2015), HMRC's most recent estimate was £4.5 billion in 2013-14. This was then grown in line with our forecasts at the time for the relevant tax streams, increasing the estimated loss to £5.7 billion by 2020-21.

The introduction of digital record-keeping was then assumed to reduce taxpayer errors, with the removal of those errors favouring the taxpayer outweighing the removal of those favouring the Exchequer – thereby delivering a positive yield. This judgement was based on two pieces of qualitative research, one commissioned by HMRC and another by the Office of Tax Simplification. Leaving aside deliberate non-compliance, errors are assumed on balance to be in taxpayers' favour because most businesses filing returns will have tax to pay, with sales that exceed expenses. If record-keeping errors are of the same proportion in both sales and expense invoices, this results in a net under-declaration of tax liabilities. That said, the costing did take account of the removal of some errors that favour the Exchequer.

The costing was also adjusted for the expected evolution of take-up. Although digital record-keeping is mandatory for those in scope of the measure, take-up was assumed to increase from the initial testing phase to full mandation. Take-up was also adjusted for the staggered start dates for SA, VAT and CT.

When we certified this costing we gave it a 'high' uncertainty ranking, based on the potential behavioural response and concerns over the delivery timetable. In terms of behaviour, the uncertainty relates to the extent to which the software will prevent taxpayer errors. In terms of deliverability, the uncertainty relates to the challenging scale and scope of the project. Reflecting lessons from previous costings, and the experience of delays in the rollout of a number of welfare spending reforms, we paid particular attention to the degree of contingency built into the delivery plan before certifying the costing as central. That included evidence from a Major Projects Authority review. We continue to monitor progress against the plan at each forecast.

Table 1 shows the costing from Autumn Statement 2015 and the subsequent recostings at Budget 2016, Autumn Statement 2016 and Budget 2017. The movements in the costing reflect changes to the estimated amount of tax lost through error and failure to take reasonable care and to the underlying forecasts. This includes the effect of the ONS decision to time-shift cash corporation tax receipts so that they are recorded closer to the time when the economic activity that created the liabilities took place. These changes explain most of the increase in the estimated yield.

**Table 1: Costings for record-keeping element**

| | £ million | | | | |
|---|---|---|---|---|---|
| | Forecast | | | | |
| | 2017-18 | 2018-19 | 2019-20 | 2020-21 | 2021-22 |
| Autumn Statement 2015 | - | +10 | +300 | +610 | NA |
| Budget 2016 | - | +10 | +310 | +625 | NA |
| Autumn Statement 2016 | - | +10 | +400 | +795 | +935 |
| Budget 2017 | - | +10 | +400 | +805 | +965 |

Take-up will be affected by the policy decisions taken at this Budget and described above. Their relatively modest fiscal impact is shown in Table 2. The one-year deferral was presented on the Treasury's 'scorecard' of Budget policy measures (Table 2.1 in the Red Book), but the 'use of spreadsheets' element was not. We reported the costing for that decision in Table A.1 of our March *Economic and fiscal outlook*, which recorded the fiscal effects of a number of policy changes that were not presented on the scorecard.

**Table 2: Budget 2017 decisions**

| | 2018-19 | 2019-20 | 2020-21 | 2021-22 |
|---|---|---|---|---|
| Making Tax Digital: one year deferral below the VAT threshold | -20 | -65 | -150 | -45 |
| Making Tax Digital: use of spreadsheets | - | -20 | -40 | -45 |

### Administrative burden

You asked whether and how we had considered the wider economic effect of 'making tax digital' – in particular, the administrative burden on small businesses associated with quarterly reporting. The official Government estimate of this burden is significantly lower than that produced by the Federation of Small Businesses, which was referenced in questions to us at the 13 March hearing. We did not scrutinise the Government's estimate, as it did not constitute part of the policy costing for the digital record-keeping element that is currently factored into our forecasts.

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According to HMRC, this measure will affect *"around 3.3 million self-employed individuals (including around 900,000 landlords), 1.6 million companies, over 400,000 ordinary partnerships, and about 600,000 businesses with income from different sources (for example, both self-employment and property)"*. HMRC claims there will be both costs and savings to business, and estimate a net cost in the initial transition period but a net saving in the long-term.[1] These estimates do not include the CT impact of 'making tax digital'. As set out in Table 3, HMRC expects businesses to face initial 'transitional costs' as well as ongoing 'steady-state costs' that include software subscription costs and costs of making quarterly updates. In the longer term HMRC claims this will be offset by savings from a reduction in *"time spent complying with existing ITSA (income tax self-assessment) and VAT obligations"*.

**Table 3: HMRC estimate of administrative burden**

| | £ million | | | | | |
|---|---|---|---|---|---|---|
| | Forecast | | | | | |
| | 2017-18 | 2018-19 | 2019-20 | 2020-21 | 2021-22 | 2022-23 |
| Steady-state costs | - | +50 | +150 | +170 | +170 | +170 |
| Admin burden savings | - | - | -150 | -270 | -270 | -270 |
| Transitional costs (one-off) | +100 | +200 | +590 | +100 | - | - |
| **Net impact** | **+100** | **+250** | **+590** | **0** | **-100** | **-100** |

Source: HMRC

The Federation of Small Businesses has estimated that the compliance costs associated with 'making tax digital' will be significantly higher – at around £2,770 per year per small and medium-sized business for 'introducing mandatory quarterly reporting'.[2]

Regardless of which of these estimates is a better reflection of the true administrative cost or gain *to small business* of 'making tax digital', neither is comprehensive in terms of measuring the wider economic impact. As such, they do not provide a sound basis for considering the wider economic effects. For example, if a small business incurs additional costs from purchasing new software or requiring accounting advice on a quarterly rather than an annual basis, those costs will represent additional revenue for the providers of the software or accountancy services. It is the net effect of these flows that will determine any impact on the wider economy. It seems likely that this would be negligibly small at the whole economy level.

Best regards,

Robert

Robert Chote
**Chairman**

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1 https://www.gov.uk/government/publications/making-tax-digital-for-business/making-tax-digital-for-business

2 http://www.fsb.org.uk/docs/default-source/fsb-org-uk/fsb-mtd-pwc-report.pdf