

Public Audit Committee
Thursday, 25 April 2024
13th Meeting, 2024 (Session 6)

Administration of Scottish income tax 2022/23

Introduction

1. At its meeting today, the Public Audit Committee will take evidence from HM Revenue and Customs (HMRC) and the Scottish Government on the administration of Scottish income tax 2022/23.
2. The Committee previously took evidence from the Comptroller and Auditor General (C&AG) and the Auditor General for Scotland (AGS) on the National Audit Office (NAO) report on the Administration of Scottish income tax 2022/23 and the AGS's assurance report on [22 February 2024](#).

Background

3. 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).
4. The C&AG is required to report to the Scottish Parliament on HMRC's administration of Scottish income tax. His ninth report on Scottish income tax for the reporting period 2022/23 can be found at **Annexe A**.
5. When the predecessor Public Audit Committee published its report, [Framework for auditing Scottish income tax](#) in 2014, it recommended that the AGS should provide additional assurance on the NAO's audit work. The AGS's report can be found at **Annexe B**.

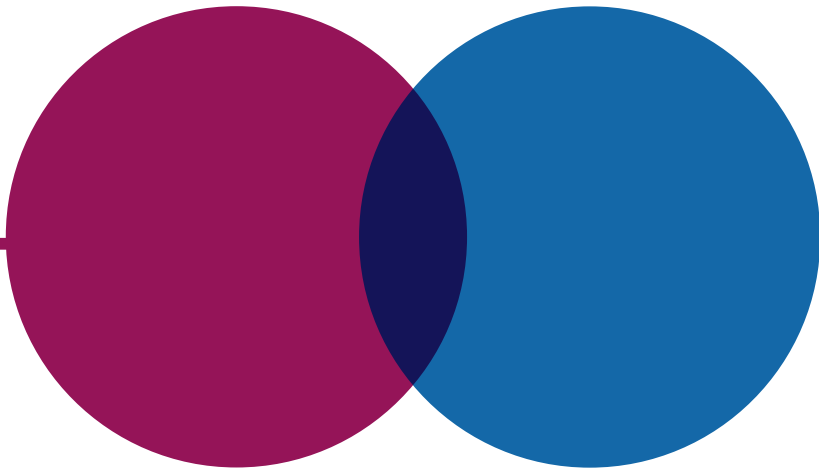
Previous consideration of the Administration of Scottish income tax

6. The Public Audit Committee considers the administration of Scottish income tax on an annual basis. Information relating to the Committee's scrutiny of previous C&AG and AGS reports in this current session of Parliament, including links to Official Reports and written evidence can be found below as follows—

- [Administration of Scottish income tax 2020/21](#)
- [Administration of Scottish income tax 2021/22](#)

7. The Committee will decide any further action it wishes to take following the evidence session today.

Clerks to the Committee
April 2024




REPORT

Administration of Scottish income tax 2022-23

HM Revenue & Customs

SESSION 2023-24
19 JANUARY 2024
HC 388

SG/2024/14



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National Audit Office

Administration of Scottish income tax 2022-23

HM Revenue & Customs

Report by the Comptroller and Auditor General

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National Audit Office

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Key facts

2.7mn

Scottish taxpayers
in 2021-22

£13.7bn

Scottish income tax
revenue in 2021-22

£15.0bn

HM Revenue & Customs'
estimate of Scottish income
tax revenue in 2022-23

£0.6 million costs of administering Scottish income tax in 2022-23

Summary

Introduction

1 The Scotland Act 2016 gave the Scottish Parliament power to determine the tax bands and rates (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 has set income tax rates differently in Scotland to the rest of the UK. It uses the five-band system first introduced in 2018-19. There are three tax bands in the rest of the UK (**Figure 1** overleaf). Scottish taxpayers pay a marginally lower rate of tax for those in the lowest band and a marginally higher rate for taxpayers earning more than £25,688. In 2022-23 rates between Scotland and the rest of the UK typically varied by a single percentage point, but the threshold at which the higher rate was payable in Scotland was lower than in the rest of the UK. For 2022-23, the amount of income subject to the starter and basic rates increased by 3.1% for Scottish taxpayers in line with CPI (Consumer Prices Index) inflation as at September 2021, while the thresholds for the higher and top rates were frozen. In the rest of the UK, all income tax rates and thresholds were frozen.

3 HM Treasury is responsible for paying Scottish income tax to the Scottish Government. HM Revenue & Customs (HMRC) administers and collects Scottish income tax as part of the UK tax system. It 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 2.7 million Scottish taxpayers in 2021-22.

4 Following the end of each tax year, HMRC produces a provisional estimate of Scottish income tax revenue for that year. It calculates the final outturn the following year once it has received further information from taxpayers and employers. This report covers the final outturn for 2021-22 and the provisional estimate for 2022-23. HMRC expects to publish the outturn for 2022-23 in its 2023-24 Annual Report and Accounts.

Figure 1

Income tax rates and bands in Scotland and the rest of the UK for 2022-23

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 14,732	19	–	–
Basic rate	14,733 to 25,688	20	12,571 to 50,270	20
Intermediate rate	25,689 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 The top rate 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 August 2023; and HM Revenue & Customs, *Income Tax in Scotland*, available at: www.gov.uk/scottish-income-tax, accessed August 2023

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 HMRC is complying with these rules and procedures;
- the correctness of the sums brought to account by HMRC which relate to income tax that is 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 2021-22 income tax revenue for Scotland (the 'outturn') and assurance on the correctness of amounts brought to account (Part One);
- HMRC's estimate of the 2022-23 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 the agreement between HMRC and the Scottish Government (Part Three).

7 For the 2023-24 tax year, the top rate of income tax in Scotland increased from 46% to 47% and the higher rate of income tax increased from 41% to 42%. The level at which taxpayers pay the top rate of income tax reduced from £150,000 to £125,140 for taxpayers in both Scotland and the rest of the UK. For the 2024-25 tax year, the top rate of income tax will increase further to 48%, and a new advanced rate of income tax, at 45%, will apply to incomes between £75,000 and £125,140.

8 Appendix One sets out our audit evidence base.

Key findings

Scottish income tax 2021-22 final outturn and 2022-23 estimate

9 HMRC calculated the final outturn for 2021-22 as £13,724 million, representing amounts collected under Scottish income tax policy. HMRC's estimate of 2021-22 Scottish income tax revenue, published in July 2022, was £13,295 million, meaning the actual outturn was £429 million (3.2%) higher than HMRC had originally estimated. We examined HMRC's methodology for calculating the actual outturn, which necessarily includes some remaining areas of estimation, for instance where HMRC had not yet received returns from taxpayers. In these areas, we have evaluated the basis of HMRC's estimates, including the relevant assumptions and available data. Based on that audit work, we have concluded that the Scottish income tax revenue outturn for 2021-22 is fairly stated (paragraphs 1.2 to 1.16).

10 HMRC has estimated Scottish income tax revenue for 2022-23 as £14,996 million. This represents an increase of £1,272 million (9.3%) compared with the 2021-22 outturn. Income tax for the whole of the UK increased by 8.9% in 2022-23. These increases reflect inflationary rises in earnings, together with the freezing of the thresholds for the higher and top rates of income tax in Scotland and all income tax bands and thresholds in the rest of the UK, moving some taxpayers into higher tax brackets. HMRC expects to calculate the finalised 2022-23 income tax outturn attributable to Scotland in 2024. The estimate HMRC produces is solely for financial reporting purposes in its annual accounts and does not affect the amount of revenue that the Scottish Government ultimately receives, which is based on independent forecasts from the Scottish Fiscal Commission and the Office for Budget Responsibility (paragraphs 1.17 to 1.21).

11 External factors have increased the level of uncertainty in HMRC's estimate of Scottish income tax revenue in the past two years. HMRC identifies the key source of uncertainty as the accuracy with which it can estimate Scotland's share of UK income tax liabilities, particularly since its estimate for 2022-23 relies on survey data from 2019-20. The outturn for 2021-22 was 3.2% higher than HMRC had originally estimated, compared with the years between 2018-19 and 2020-21 where the outturn was within approximately 1% of HMRC's estimates. HMRC said there was stronger growth than it expected in Self Assessment liabilities in 2021-22, and the COVID-19 pandemic created additional uncertainty in the amount of tax accrued and collected. HMRC has highlighted high interest rates and inflation, wage growth and high and volatile energy prices as external factors causing increased uncertainty in 2022-23. We consider the approach adopted by HMRC to estimating the impact of these areas of uncertainty on Scottish income tax revenue in 2022-23 to be reasonable (paragraph 1.22).

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 it is complying with those rules. 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 HMRC's 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 an increase in the number of Scottish postcodes identified by HMRC's address-cleansing work as either missing or invalid, with 1.6% (41,923) of the overall taxpayer population identified as either missing or invalid in its 2022-23 annual scan in November 2022. This had increased from 1.0% (25,488) in the 2021-22 scan in June 2021. HMRC has investigated and updated those cases with taxable income during the year (paragraphs 2.18 to 2.20 and Figure 9).

14 The divergence between the tax regimes in Scotland and the rest of the UK in 2022-23 remained broadly the same as in 2021-22. 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, where taxpayers in Scotland pay £1,489 more than in the rest of the UK. HMRC continues to assess the risk of a Scottish taxpayer manipulating their address to minimise their tax liability and monitors data on taxpayers changing their address or migrating out of Scotland. HMRC has not identified any significant or widespread instances of taxpayers changing their address to obtain a tax advantage (paragraphs 2.16 and 2.17 and Figure 8).

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, although this assessment relies on information with a significant time-lag. In 2022-23, HMRC produced a Strategic Picture of Risk (SPR) for Scottish income tax. It considers the main areas of risk to Scottish income tax to be the same as those compliance risks which it assesses at the whole-of-UK level. There are no risks that HMRC identifies in this 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 from 2023-24 when income tax rates in Scotland will diverge further from the rest of the UK. However, HMRC told us that compliance activity typically applies to tax liabilities from two years previous and so any increased risk is unlikely to be apparent through compliance cases until at least 2025-26. For 2023-24, the Scottish Government has commissioned HMRC to establish a more reliable baseline of cross-border migration and to better understand whether this risk is materialising (paragraphs 2.30 to 2.35).

16 HMRC calculated a compliance yield of £380 million relating to Scotland for 2021-22, 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 estimated that Scotland's share of net losses from compliance risks in 2020-21, the most recent data available, was £1.1 billion. 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 2.39).

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 2.37).

18 HMRC's compliance activities increased in 2022-23 but it failed to meet its target for compliance yield. Across the UK, the number of compliance cases that HMRC opened in 2022-23 was higher than in 2021-22 but 17% lower than in 2019-20 before the COVID-19 pandemic. It closed 20% fewer cases than in 2019-20. HMRC says this partly reflects its strategy to focus increasingly on upstream efforts to ensure taxpayers comply in the first place, and to prioritise larger and higher-impact cases. HMRC's yield from its tax compliance activities for the whole of the UK was £34.0 billion in 2022-23, up 10% compared with 2021-22 and higher than the average over the past five years (2018-19 to 2022-23) of £33.2 billion. Compliance yield in 2022-23 was, however, below HMRC's target of £36 billion. As a proportion of total revenue, compliance yield remained unchanged at 4.2% (paragraphs 2.36 to 2.38).

19 UK tax debt has increased since 2022 and 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 2023, total tax debt for the UK was £43.9 billion, 11.9% (£4.7 billion) higher than the level of debt that HMRC reported at 31 March 2022. Tax debt more than trebled in the first six months of 2020-21 due to the wider economic impact of the COVID-19 pandemic and HMRC's decision to suspend most debt collection. It remains higher than the five years leading up to the pandemic when tax debt was typically around £14 billion. HMRC has a new strategy to bring down tax debt in the long term but expects it to remain high throughout 2023-24. HMRC last 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 By comparison, Scotland receives 6.6% of income tax revenue. HMRC attributed some £0.9 billion of this to debts from Pay As You Earn (PAYE) and Self Assessment income tax. HMRC calculated this estimate in June 2022 in response to a question from the Scottish Public Audit Committee. It has provided no update since (paragraphs 2.41 to 2.43).

Costs

20 In 2022-23 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 2023. 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).

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.

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 2021-22 and its provisional estimate of Scottish income tax revenue for 2022-23. This includes:

- our assessment of HMRC's Scottish income tax outturn calculation for 2021-22, including data limitations and HMRC's judgements in areas of uncertainty; and
- our views on HMRC's estimate of Scottish income tax revenue for 2022-23 and the features and limitations of HMRC's methodology.

The Scottish income tax 2021-22 final outturn

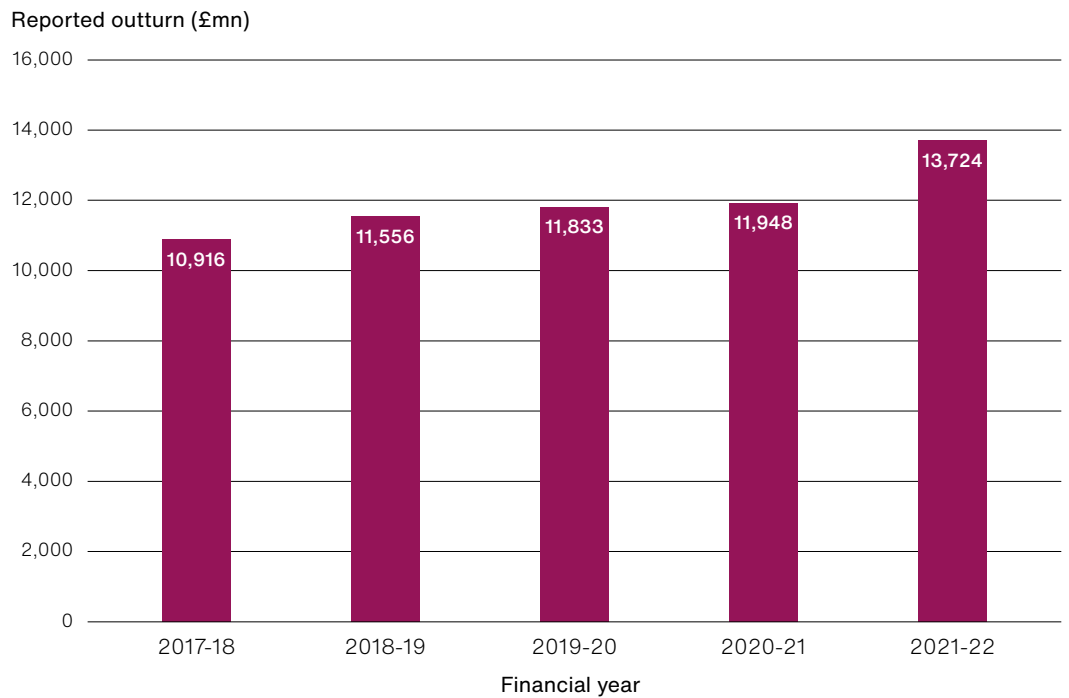
1.2 HMRC's calculation of the outturn for Scottish income tax revenue for 2021-22 is £13,724 million (**Figure 2** overleaf). HMRC calculates the final outturn figure from several components, which it aggregates to produce the total Scottish income tax liability for 2021-22. HMRC calculates each component using one or more sources of data to assess the total Scottish income tax liability.

1.3 Figure 2 shows how the outturn for Scottish income tax has changed over time. The outturn for 2021-22 represents an increase of 14.9% compared with 2020-21. The outturn for non-savings, non-dividend income tax for the whole of the UK increased by 15.4% in 2021-22.² HMRC attributes the growth in Scottish income tax in 2021-22 to higher nominal earnings growth, likely due to economic recovery following the pandemic and tight labour market conditions during a period of increasing inflation. HMRC's estimate of 2021-22 Scottish income tax revenue, published in July 2022, was £13,295 million, meaning the actual outturn was £428 million (3.1%) higher than HMRC had originally estimated. In contrast, in the years between 2018-19 and 2020-21 the outturn was within approximately 1% of HMRC's estimates for those years. HMRC explained this was because Self Assessment liabilities had increased in Scotland by more than it expected. The COVID-19 pandemic also created additional uncertainty in the amount of tax that would be accrued and collected.

2 HM Revenue & Customs, *Scottish Income Tax Outturn Statistics: 2021 to 2022*, July 2023.

Figure 2

Reported outturn for Scottish income tax revenue, 2017-18 to 2021-22

Scottish income tax revenue increased by 14.9% in 2021-22 to £13,724 million**Note**

1 All data are nominal amounts, meaning they have not been adjusted for inflation.

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

1.4 HMRC largely based the outturn calculation on established tax liabilities, some £13,824 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.

1.5 HMRC makes adjustments or estimates where it has not yet finalised the tax due, or where it must estimate the Scottish share of uncollectable amounts or tax reliefs. The reduction in Scottish income tax outturn arising from these adjustments was £100 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.

Figure 3

HM Revenue & Customs' (HMRC's) calculation of the 2021-22 Scottish income tax revenue outturn

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

	2021-22			2020-21
	Amounts based on established taxpayer liabilities	Adjustments and amounts based on estimated liabilities	Total	Total
	(£mn)	(£mn)	(£mn)	(£mn)
Self Assessment established liabilities ¹	6,123	(77)	6,047	5,116
Pay As You Earn (PAYE) established liabilities ¹	7,701	(5)	7,695	6,884
Estimated further liabilities ²	-	372	372	315
Deductions from revenue ³	-	(389)	(389)	(366)
Total	13,824	(100)	13,724	11,948

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 2022-23*, HC 1466, July 2023 and National Audit Office analysis of HM Revenue & Customs data

1.6 HMRC and the Scottish Government discussed and agreed the methodology used to calculate the 2021-22 outturn for Scottish income tax at the Scottish Income Tax Board in May 2023. The methodology HMRC used to calculate the outturn has remained broadly the same since the prior year.

1.7 We examined the methodology for the outturn calculation, which necessarily includes some remaining areas of estimation, for instance where HMRC had not yet received returns from taxpayers. 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 2021-22 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 £6,047 million represents all income tax attributable to Scotland from Scottish Self Assessment taxpayers in 2021-22.

1.9 HMRC identifies Scottish taxpayers by using its record of Scottish residency status in its Computerised Environment for Self Assessment (CESA) system. The calculation of Self Assessment liabilities is mainly based on the extraction of Scottish taxpayers 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 £7,695 million represents all income tax attributable to Scotland from Scottish PAYE taxpayers in 2021-22.

1.11 Under PAYE, employers submit data monthly to HMRC on the earnings and tax deductions made for their employees and HMRC records this information in its National Insurance and PAYE Service (NPS) system. HMRC identifies Scottish taxpayers in the NPS using a residency indicator based on taxpayer postcode information. HMRC identifies the total Scottish income tax liabilities by extracting Scottish taxpayer records from the NPS.

1.12 Most PAYE liabilities are based on Scottish taxpayer data extracted from the NPS but some apportionment of other smaller elements is required. HMRC deducts from the total the Scottish share of tax reliefs given against PAYE liabilities. HMRC also makes an adjustment to apportion the tax it collects from employers under PAYE settlement agreements.⁴ The Scottish share that HMRC calculated for 2021-22 was £23 million. As tax liabilities are settled through one payment for the employer, the identity of individual taxpayers is not recorded and, therefore, HMRC analyses employer submissions to determine the Scottish proportion of UK-wide settlement agreement revenue.

³ This includes an estimate of £21 million from manually entered liabilities and assessments, which do not provide a split of the liability between taxes. It also includes sensitive records, which HMRC does not access when calculating Scottish income tax. HMRC deducted a sum of £117 million 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 2021-22 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 £372 million in the 2021-22 outturn. HMRC made an estimated adjustment of £2,731 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 was still outstanding. Improved IT processes have helped reduce this from £10 million in 2020-21.

Deductions from revenue

1.14 HMRC makes a series of deductions from the outturn revenue, recognising that in practice it will not collect all taxpayer liabilities. 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 analyses historical data for the UK as a whole to determine patterns of uncollected liabilities and then apportions an amount relating to Scottish taxpayers. HMRC calculated this to be £94 million for 2021-22.

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 calculates 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 £119 million for 2021-22 and pension contributions to be £176 million.

The Scottish income tax estimate for 2022-23

1.17 HMRC estimates it will collect £14,996 million of Scottish income tax revenue relating to the 2022-23 year.⁵ This represents an increase of £1,272 million (9.3%) against the 2021-22 outturn. There was an 8.9% increase for the UK overall against the 2021-22 outturn. These increases reflect inflationary rises in earnings, together with the freezing of the higher and top rates of income tax in Scotland and all income tax bands and thresholds in the rest of the UK, moving some taxpayers into higher tax brackets. HMRC expects to publish the final outturn for the 2022-23 year in its 2023-24 Annual Report and Accounts by July 2024. HMRC's estimate is solely for financial reporting purposes in its annual accounts. It does not affect the amount of revenue that the Scottish Government receives, which is based on independent forecasts of Scottish income tax from the Scottish Fiscal Commission and the Office for Budget Responsibility. An adjustment to the budget is made in later years once HMRC confirms the final outturn.

1.18 HMRC's methodology to estimate Scottish income tax revenue for 2022-23 is based on taxpayer data from its Survey of Personal Incomes. The latest data available to HMRC at the time it produced the estimate were from 2020-21, but HMRC assessed these data would be less indicative of future years given the distorting impact of the COVID-19 pandemic. It instead used Survey of Personal Incomes data from 2019-20. HMRC then determined Scotland's percentage share of the overall UK income tax liability by analysing data in a model replicating the UK income tax system, known as the Personal Tax Model. HMRC adjusted the data to reflect demographic and policy changes that it expects or knows have taken place between 2019-20 and 2022-23. HMRC then applied Scotland's share 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. HMRC's methodology is largely unchanged from that it used to calculate the 2021-22 estimate.

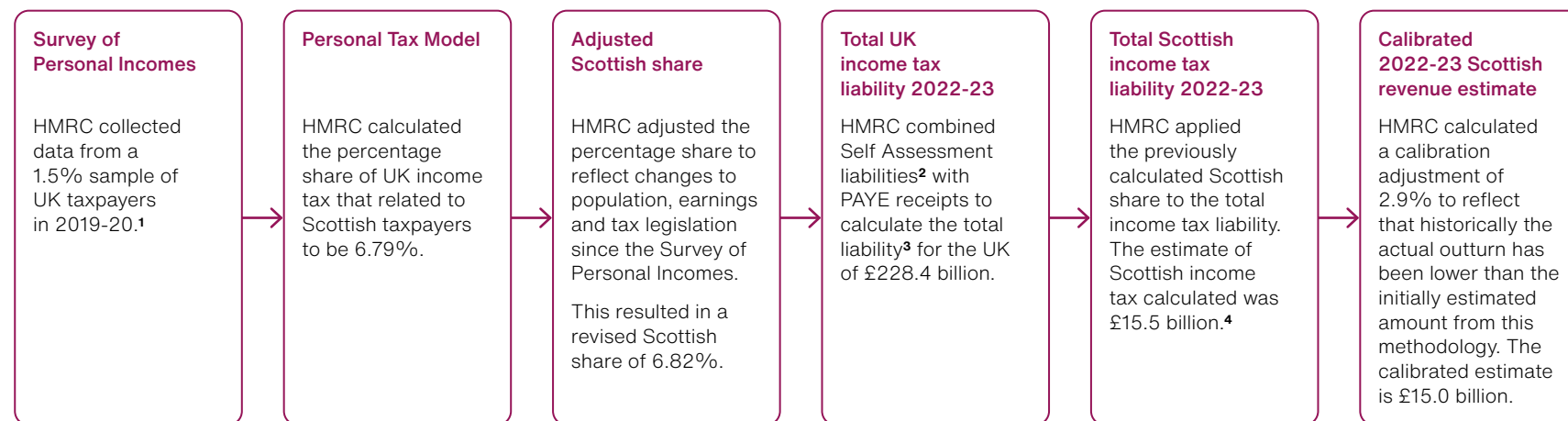
1.20 HMRC made a 'calibration' adjustment to the revenue estimate because its methodology has historically resulted in actual outturn being lower than estimated outturn. HMRC made this adjustment by comparing the 2021-22 outturn with a revised estimate of 2021-22 revenue using the same methodology but with the most recent assumptions and data. The impact of the calibration adjustment reduced the 2022-23 provisional estimate by £0.5 billion (2.9%) (see Figure 4).

⁵ HM Revenue & Customs, *Annual Report and Accounts 2022-23*, HC 1466, July 2023.

Figure 4

HM Revenue & Customs' (HMRC's) method for calculating the Scottish 2022-23 income tax revenue estimate

HMRC's 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 2022-23, 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

1.21 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 2022-23:

- The calibration adjustment assumes the 2022-23 over-estimation is consistent with 2021-22 in percentage terms, but HMRC does not fully understand the causes of the over-estimate in 2021-22 and any socioeconomic factors contributing to the over-estimate may be different in 2022-23.
- HMRC's use of sample data introduces sampling uncertainty into the revenue estimate from which HMRC calculates the Scottish portion as a percentage.
- The methodology combines the calculation of PAYE and Self Assessment liabilities for the UK such that the amount HMRC apportioned to Scotland does not reflect the differing proportions of each type of taxpayer between Scotland and the rest of the UK.
- The data that HMRC uses for PAYE include all income types and do not exclude tax from savings and dividend income.
- HMRC must make an assumption around the volume and value of under- and over-payments relating to PAYE liabilities.

1.22 HMRC identified the key source of uncertainty in the 2022-23 estimate as the accuracy with which it can estimate Scotland's share of UK income tax liabilities. The estimated share that HMRC calculates is based on 2019-20 survey data so there is an inherent risk that this could change for Scotland by 2022-23. HMRC estimates that Scottish income tax liabilities will grow at a slightly higher rate than the UK overall given lower thresholds and higher rates of income tax in Scotland. External factors creating additional uncertainty around estimating Scotland's share in 2022-23 included high interest rates and inflation, wage growth and high and volatile energy prices. We consider that HMRC has taken a reasonable approach to estimating the impact of these areas of uncertainty on Scottish income tax revenue in 2022-23.

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 how we have obtained 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 2.28); and
- how HMRC identifies and responds to compliance risks (paragraphs 2.29 to 2.43).

2.2 HMRC uses the same systems to administer income tax whether it comes 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 2022-23 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 HMRC's ongoing maintenance of Scottish taxpayer records, and how it identified and responded to devolved tax compliance risks.

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 HMRC 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:

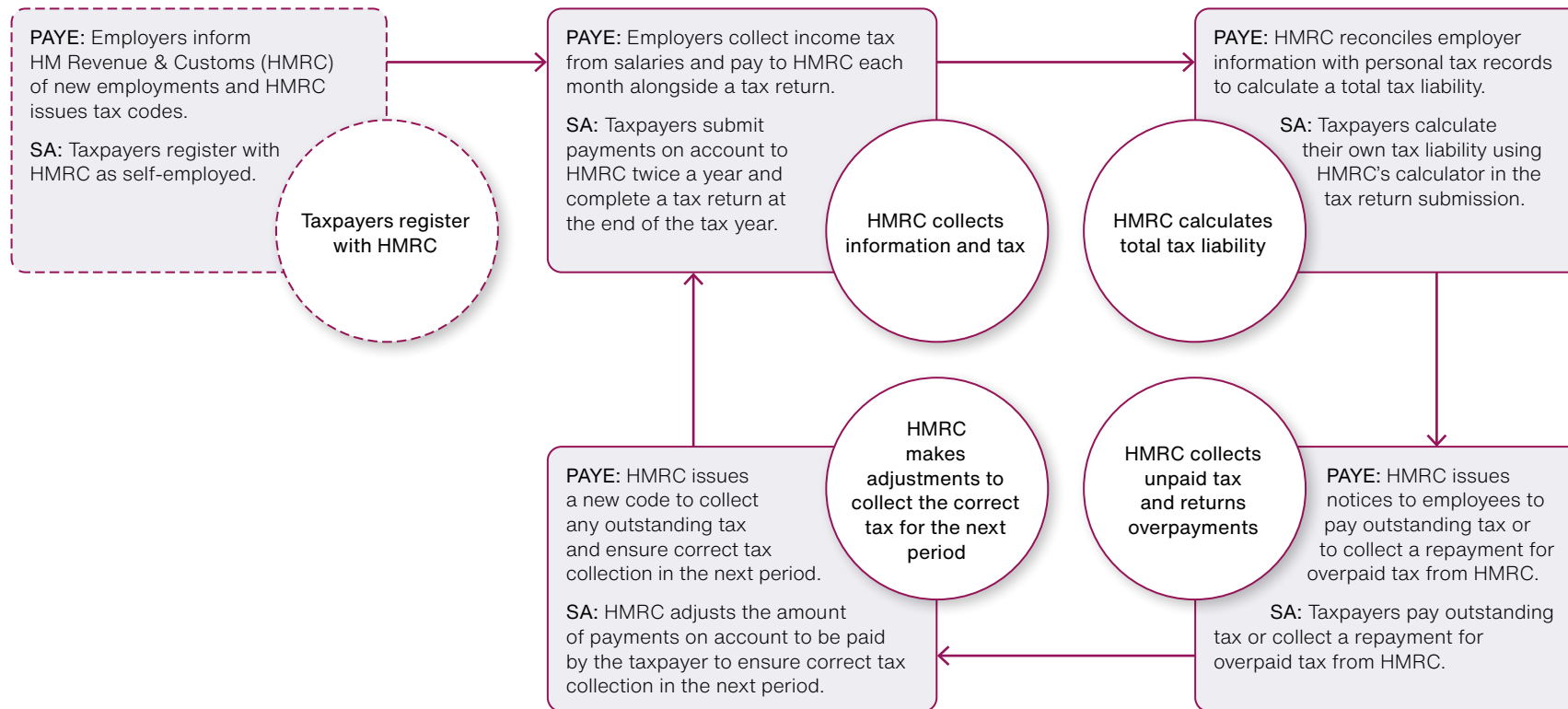
- reconciling of employer information with personal tax records to confirm tax due on earnings and calculate any over- or under-payments of tax based on country of residence; and
- issuing of tax codes to PAYE taxpayers which incorporate residency information to ensure employers deduct tax under the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

2.9 HMRC applies similar processes to each individual Self Assessment return that it 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 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 2021-22. The rules that the HMRC system applies for Scottish taxpayers are as follows:

- It 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 system removes the 'S' prefix.
- Where the system identifies an individual as a Scottish resident, it applies Scottish tax rates and bands 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.

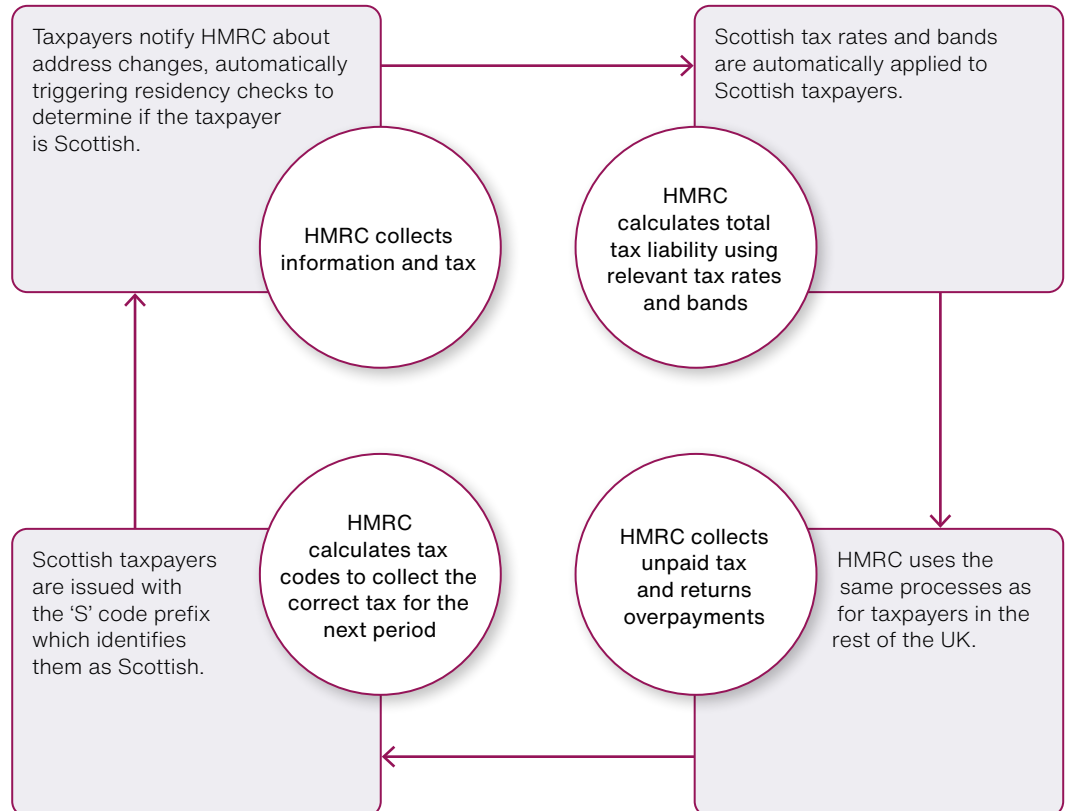
Tax relief on pension contributions

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 2021-22 tax year, a similar proportion as in the past five years. A Scotland-specific figure is not available. Following the 2021-22 tax year, HMRC issued Annual Notification of Residency Reports to pension scheme administrators in January 2023.

Tax relief on Gift Aid contributions

2.14 HMRC provides tax relief on Gift Aid contributions in Scotland 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, HMRC applies the correct rate of relief when it 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 2.7 million Scottish taxpayers in 2021-22, which is a 5.1% increase from 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 16.4% of the Scottish income tax population in 2021-22 (up from 14.9% in 2020-21) and contributed 62.5% of tax paid (up from 59.8% in 2020-21). These increases reflect the freezing of tax rates and the movement of taxpayers into higher tax brackets. Starter-rate and basic rate taxpayers accounted for just under half of the population (48.7%) and provided around 10% of tax paid (**Figure 7**).

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

2.16 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 that amount paying 20% more than a taxpayer elsewhere in the UK (£8,975 in Scotland compared with £7,486 in the rest of the UK) (**Figure 8** on page 26). 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.

2.17 In 2022-23, the divergence between the tax regimes in Scotland and the rest of the UK remained broadly the same as in 2021-22. For 2023-24, the tax regimes diverged further, with the Scottish Government increasing the top rate of income tax from 46% to 47% and the higher rate of income tax from 41% to 42%. The level at which taxpayers pay the top rate of income tax reduced from £150,000 to £125,140 for taxpayers in both Scotland and the rest of the UK. Figure 8 shows how these changes will increase the amount of tax paid by Scottish taxpayers earning around £50,000 or more.

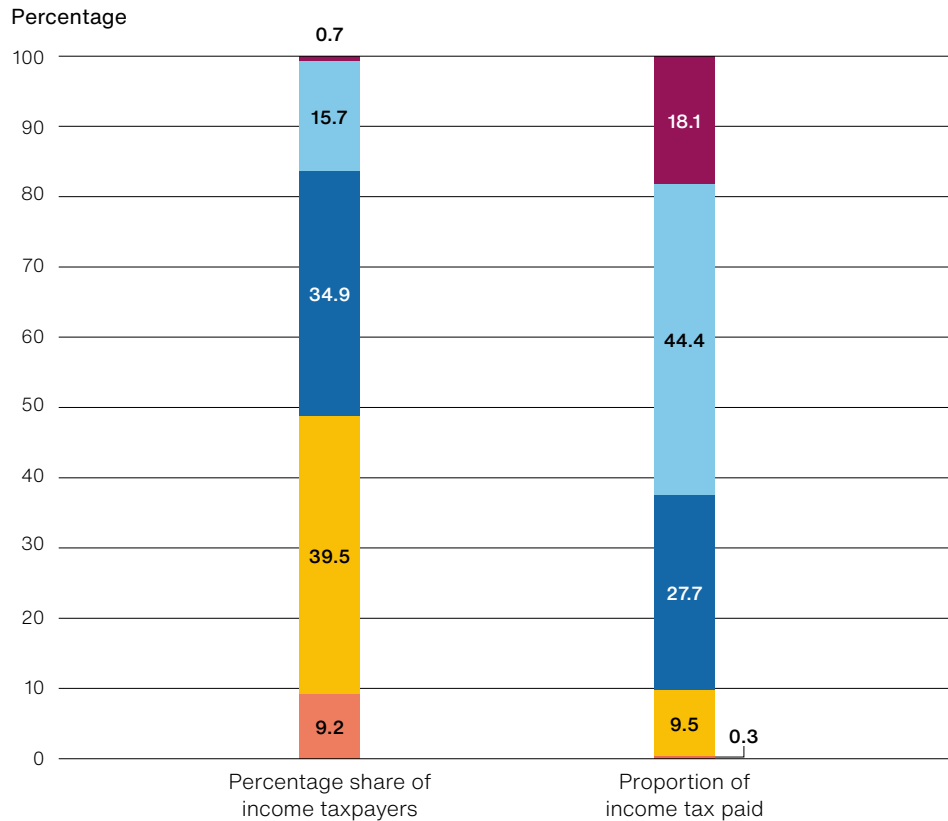
⁶ HM Revenue & Customs, *Scottish Income Tax Outturn Statistics: 2021 to 2022*, July 2023.

⁷ Scottish parliamentarians are also deemed Scottish taxpayers. See paragraph 2.28 for more details.

Figure 7

Proportion of income taxpayers by band and income tax paid by band in Scotland, 2021-22

Higher rate and top rate income taxpayers accounted for 16.4% of the population and contributed 62.5% of income tax paid



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

Note

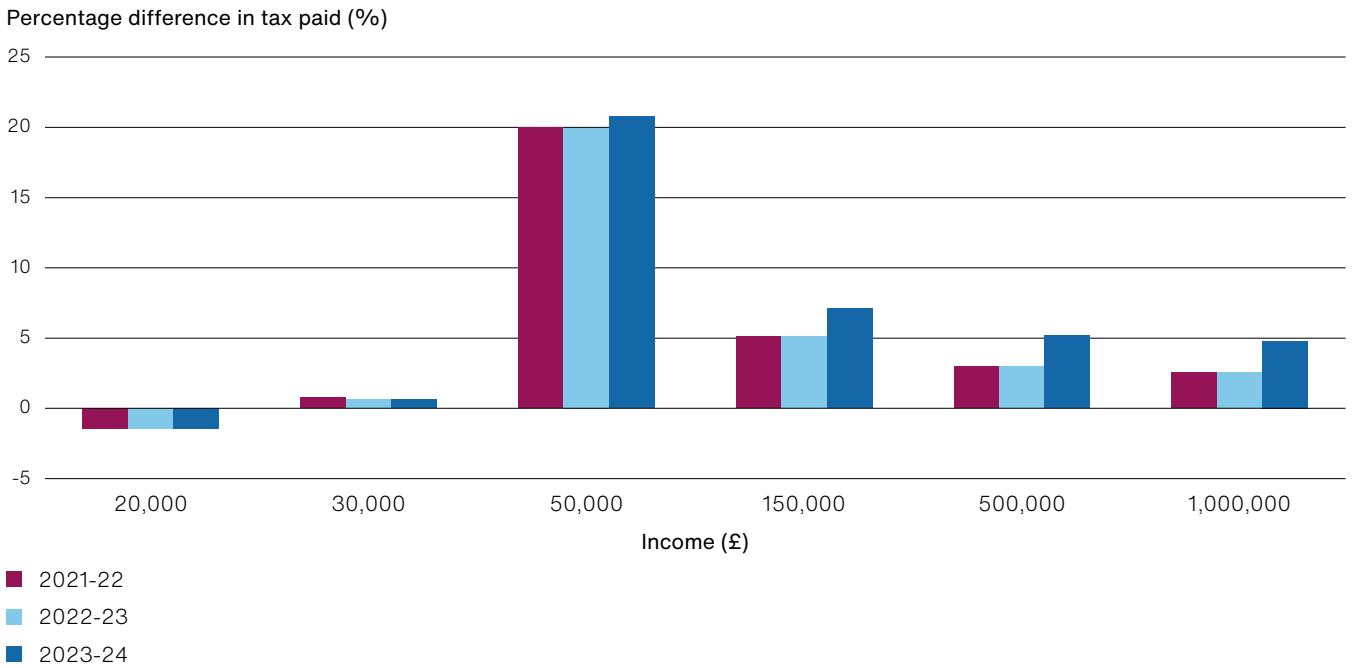
1 2021-22 is the latest year for which data are available.

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

Figure 8

Differences in the tax liability between taxpayers in Scotland and in the rest of the UK, 2021-22 to 2023-24

Compared with 2021-22, income tax liabilities in Scotland remained broadly the same in 2022-23, although will diverge further in 2023-24, particularly for taxpayers earning £50,000 or more



Income (£)		20,000	30,000	50,000	150,000	500,000	1,000,000
Difference compared with UK income tax (%)	2021-22	-1.4	0.7	20.0	5.1	2.9	2.6
	2022-23	-1.5	0.6	19.9	5.1	2.9	2.6
	2023-24	-1.5	0.6	20.7	7.2	5.1	4.8
Difference compared with UK income tax (£)	2021-22	-21	26	1,494	2,673	6,173	11,173
	2022-23	-22	22	1,489	2,669	6,169	11,169
	2023-24	-22	22	1,552	3,858	10,858	20,858

Notes

- 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.
- 2 A negative figure indicates that the amount and/or relative percentage of income tax paid in Scotland is less than in the rest of the UK.

Source: National Audit Office analysis of income tax rates and bands in Scotland and the UK for 2021-22 to 2023-24

Address assurance

2.18 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.

2.19 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 9** overleaf).

Postcode scans

2.20 HMRC scans taxpayer records to identify missing or invalid postcodes which would result in an incorrect residency status being applied. The 2022-23 scan, performed in November 2022, identified 41,923 postcodes either missing or invalid (1.6% of the overall taxpayer population), compared with 25,488 (1.0%) in the previous scans in June 2021 and 61,213 (2.4%) in September 2020. HMRC told us it expects these numbers to always fluctuate but could not provide an explanation for what caused the increase in 2022-23. HMRC investigates and updates all cases where individuals were either employed or receiving a pension. In 2022-23, HMRC updated 1,567 records, compared with 3,031 in 2021-22 and 9,429 in 2020-21. Cases that HMRC has not updated are identified as dormant because they have no current taxable income.

The administration of Scottish tax codes

2.21 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.

2.22 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.

Figure 9

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	Description and 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.	HMRC receives postcode data quarterly from the ONS. It added 1,138 new postcodes in 2022-23.
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 November 2022 identified 11,551 missing postcodes. HMRC updated 757 of these cases because they had a record of current employment or pension. HMRC also identified 30,372 invalid postcodes and updated 810 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 it determines the correct residency.	In 2022-23, HMRC reviewed 37 cross-border cases, of which it amended eight following investigation.
Missing residency flags	Scans to identify Scottish taxpayer records that are not flagged as such in the system.	HMRC's scans during 2022-23 identified 5,712 cases, all of which it 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 January 2023 HMRC identified 37,324 cases where 'S' prefixes were not correctly applied to tax codes. ² It writes to employers to ask them to update the incorrect tax codes.
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 August 2023 and compared 5.3 million Scottish address records. HMRC identified 8,540 records where the residency determined from the address held by HMRC did not match the residency suggested by third-party data.
Wealthy individuals	HMRC performs checks and procedures to review the movements of wealthy individuals and ensure their addresses are up to date. Specialist teams develop an in-depth understanding of the finances, behaviours and compliance risks of these taxpayers.	

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 analysis of HM Revenue & Customs activities

2.23 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. In January 2023, there were 37,324 cases (1.3% of cases) where employers were not operating a tax code with an 'S' prefix. This number varies across the year but has remained below 1.5% since April 2020. 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.

2.24 When HMRC identifies that 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 who repeatedly use the incorrect tax code is very low and so it does not routinely track this information. For 2023-24, the Scottish Government has requested data on the number of staff employed by each of the employers using the incorrect tax code.

Third-party data exercise

2.25 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.

2.26 In August 2023, 5.3 million records held by HMRC were compared with third-party data, showing that:

- 3.9 million records (72.9% of records analysed) held by HMRC were successfully matched to third-party data with a Scottish address. This is an increase from 72.2% in the previous third-party data exercise in 2021 though remains lower than the 78.7% matched in 2019;
- 8,540 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 (27.0% 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

⁸ Approximately 71,000 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.

2.27 The results from the 2023 exercise became available in December 2023 and HMRC has not yet assessed what factors contributed to any trends in data. For the decline between 2019 and 2021 in the proportion of records matched to third-party data, HMRC identified several potential factors, including: the impact of data protection regulations on third-party data sets; a higher death-rate due to the COVID-19 pandemic; the inclusion of 16- to 18-year-olds on the electoral roll; and an increase in people changing address.

Scottish parliamentarians

2.28 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. HMRC introduced system changes in August 2020 designed to remove the need for it to manually update parliamentarians' records each year to record them as Scottish taxpayers. Once HMRC records a Scottish parliamentarian as a Scottish taxpayer, its system automatically overrides its normal business rules, until HMRC manually resets the override for each parliamentarian. HMRC told us that it did not identify any issues in relation to Scottish parliamentarians being recorded as Scottish taxpayers during 2022-23.

Compliance risk assessment and planning

2.29 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** to, investigating and correcting compliance risks using tailored activity when intervention is needed.

2.30 As part of its Service Level Agreement with the Scottish Government, HMRC produces an annual Strategic Picture of Risk (SPR) for Scottish income tax to assess and plan for compliance risks applicable to Scotland. For this SPR, HMRC considers key compliance risks at the overall UK level and applies a value to represent the Scottish proportion of these risks. It calculates each risk in line with Scotland's share of UK income tax in the Scottish Income Tax Outturn Statistics. HMRC does not vary the size of the proportion for each risk and has not tested its assumption that non-compliance in Scotland is the same as the rest of the UK. It said doing so would involve considerable methodological challenges and costs. As in 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.

2.31 HMRC told us that it monitors risks specific to Scottish income tax and would include these in future SPRs if it deemed appropriate. Through the data it monitors it has not identified any significant or widespread instances of taxpayers changing their address to obtain a tax advantage. Its current assessment is that this risk is still low given the level of divergence between Scottish income tax and the rest of the UK. However, with tax policy diverging further from 2023-24 there is a risk that HMRC's assessment may not be sustainable in the longer term.

2.32 HMRC has several sources of information to indicate whether this compliance risk is increasing, including the number of discrepancies from its third-party data exercise and the number of incorrect 'S' codes applied by employers for Scottish residents. It also tracks the number of compliance cases it has identified as relating to the residency status as a Scottish taxpayer. However, HMRC told us that compliance activity typically applies to tax liabilities from two years previous, therefore any compliance risk from the further divergence in tax policy between Scotland and the rest of the UK from 2023-24 is unlikely to be apparent through compliance cases until at least 2025-26. For the 2022-23 tax year, the Scottish Government did not request any specific compliance activity beyond the work undertaken as part of HMRC's UK-wide compliance approach.

2.33 HMRC also monitors cross-border migration trends to identify potential instances of taxpayers changing their address to obtain a tax advantage. Each year, it reviews taxpayers who have moved from Scotland to England and reconciles these cross-border movements to land and property transaction data. For 2022-23, HMRC has encountered difficulties with importing land and property transaction data into its systems. This has caused a delay in HMRC's plans for analysing these data, although HMRC expects the analysis to be complete by January 2024. For 2023-24, the Scottish Government has commissioned HMRC to use more sources of information to corroborate taxpayers' movements where land and property transaction data are not suitable. HMRC told us this will help establish a more reliable baseline of cross-border movements against which to monitor the impact of increased divergence in income tax rates from 2023-24.

2.34 Since 2022 HMRC has been working with the Scottish and Welsh governments to analyse cross-border migration and taxpayer characteristics over time. Since we last reported, HMRC has produced an initial version of the data set it needs for this work and has been carrying out a series of analyses, including examining the historical levels of migration across the Scottish and Welsh borders by age and income level. HMRC expects 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. The work is being funded by the UK government, Scottish Government and Welsh Government.

2.35 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 at that time 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. HMRC is now exploring broader research on individuals who choose to stop paying tax in Scotland – for example, through retirement or migration – in response to Scottish income tax changes.

HMRC's compliance activity and debt management

2.36 Across the UK, the number of compliance cases that HMRC opened in 2022-23 was higher than in 2021-22 but remained 17% lower than in 2019-20 before the pandemic. In 2022-23, it closed 20% fewer cases than in 2019-20. HMRC says this partly reflects its strategy to focus increasingly on upstream efforts to ensure taxpayers comply in the first place, and to prioritise larger and higher-impact cases.

2.37 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. HMRC 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.

2.38 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's yield from its tax compliance activities for the whole of the UK was £34.0 billion in 2022-23, up 10% compared with 2021-22 (in cash terms) and higher than the average over the past five years (2018-19 to 2022-23) of £33.2 billion. Compliance yield in 2022-23 was, however, below HMRC's target of £36 billion. As a proportion of total revenue, compliance yield remained at 4.2%. HMRC explained it was still seeing the effects of reduced compliance activity during the COVID-19 pandemic, when compliance activity was restricted and staff were temporarily redeployed to other parts of HMRC, in its 2022-23 performance.

2.39 HMRC estimates a compliance yield of £380 million in 2021-22 for Scotland's share of the risks in the SPR. HMRC also estimates that Scotland's share of net losses from the risks in the SPR was £1.1 billion in 2020-21. These data are the most recent available. 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.

2.40 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.⁹

2.41 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 2023, total tax debt for the UK was £43.9 billion, 11.9% (£4.7 billion) more than the debt reported at 31 March 2022. Tax debt more than trebled in the first six months of 2020-21 due to the wider economic impact of the COVID-19 pandemic and HMRC's decision to suspend most debt collection. It remains higher than the five years leading up to the pandemic, when tax debt was typically around £14 billion. HMRC has a new strategy to bring down tax debt in the long term but expects it to remain high throughout 2023-24.

⁹ 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

2.42 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.¹⁰ By comparison, Scotland receives around 6.6% of income tax revenue. Some £0.9 billion of the estimated tax debt 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. It has provided no update since. If Scotland's tax debt remains 5.7% of the UK total, it would stand at £2.5 billion as at 31 March 2023.

2.43 HMRC has taken steps to increase its capacity for managing debt. The number of staff in its debt management function increased from 4,289 in 2021-22 to 4,720 in 2022-23. In the Spring Budget 2023, HM Treasury gave HMRC an additional £47.2 million to improve its ability to manage tax debts, including increasing its capacity through debt collection agencies and making it easier for taxpayers to service their own debt arrangements online, for instance, by setting up time-to-pay arrangements. HMRC expects this investment to help it recover an additional £1.4 billion in tax debt between 2022-23 and 2027-28. HMRC spent £34.0 million in 2022-23 on debt collection agencies to recover tax debt, compared with £20.6 million in 2021-22, and since September 2022 it has entered a new contract that allows it to place more debt with agencies for the same level of investment. In 2022-23, private agencies recovered £813 million in tax debt, an increase from £455 million in 2021-22. HMRC manages its contracts with debt collection agencies on a UK basis and cannot provide these data for Scotland only.

2.44 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.

¹⁰ 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.

Part Three

Costs

3.1 This part considers the administrative costs invoiced to the Scottish Government from HM Revenue & Customs (HMRC) for Scottish income tax and whether they are reasonable.

3.2 Under the Service Level Agreement between 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 2022-23

3.4 HMRC invoiced the Scottish Government for £0.6 million of costs relating to the administration of Scottish income tax in 2022-23, the same as the amount HMRC recharged in 2021-22. All of the spending related to operating costs. There was a £0.1 million underspend in 2022-23 against the budget of £0.7 million. Reasons for this underspend included less time spent on Scottish income tax by HMRC staff than planned and IT savings from new contracts with third-party suppliers. There have been no significant changes to the recharging process in 2022-23.

3.5 We examined HMRC's method for estimating the costs to collect and administer Scottish income tax for the year ended 31 March 2023. 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.

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 2021-22 and the revenue estimate for 2022-23, which are described in this report. For the estimate, and where appropriate for the outturn, we applied the 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, we based our conclusion on the accuracy and fairness of the costs HMRC charged to the Scottish Government 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 2023 and July 2023.

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 September 2023 and December 2023.

Interviews with departmental officials

9 We carried out two 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 2023 and November 2023. We carried out interviews online. They typically lasted one hour and we took notes.

Quantitative analysis

12 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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Administration of Scottish income tax 2022/23



AUDITOR GENERAL 

Prepared by Audit Scotland
January 2024

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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 2022/23 HMRC Accounts in July 2023. 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 2021/22 is £13.724 billion. The net reconciliation of 2021/22 income tax will reduce the 2024/25 Scottish budget by £390 million. This is the largest adjustment to the budget resulting from the budget reconciliation to date. Reconciliations correct for the difference between forecasted tax receipts used in the Scottish budget and the actual outturn which is known later. Forecast assumptions about the path of Covid-19, unexpected extensions to the furlough scheme and relatively weaker economic performance compared the rest of the UK contributed towards this difference.
- HMRC's provisional estimate of Scottish income tax for 2022/23 is £14.996 billion. The provisional estimate is provided for financial reporting purposes and does not affect the Scottish budget. The C&AG concludes that HMRC's approach to establishing the provisional estimate is reasonable. Given continuing economic uncertainty and tax policy divergence, the Scottish Government and HMRC should keep methodologies under review

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.

as more data becomes available to ensure provisional estimates are as accurate as possible.

- The Scottish Government and HMRC should keep governance and assurance arrangements under continual review. I have previously reported that 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. I am aware that the Scottish Income Tax Board has agreed to review the frequency of the third-party data checks.
- 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 C&AG concludes that, with tax policy diverging further from 2023/24 there is a risk that HMRC's assessment may not be sustainable in the longer term. The Scottish Government should regularly consider the costs and benefits of commissioning further compliance activity in Scotland. I am aware that the Scottish Income Tax Board has commissioned an update to its Compliance Plan to further consider how HMRC's Scottish income tax compliance activity fits into its wider work to administer Scottish income tax.
- HMRC's compliance activity typically applies to tax liabilities from two years previous, therefore any compliance risk from the further divergence in tax policy between Scotland and the rest of the UK from 2023/24 is unlikely to be apparent through compliance cases until at least 2025/26. There is therefore a risk that the Scottish Government are not able to make fully informed decisions on the future divergence of Scottish income tax policy.
- HMRC together with the Scottish Government has produced 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 analysis of this dataset is under way, but it is not yet clear when or whether the results will be published. Publicly available better-quality data about taxpayer behaviour will help inform future tax policy decisions and enable more informed scrutiny.

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 2022/23 were published in July 2023. [This report relates to 2022/23](#), including the final outturn calculation of Scottish income tax for the 2021/22 tax year. This amount is used to calculate the reconciliation applied to the Scottish Budget for 2024/25.

The 2021/22 Scottish income tax outturn is reconciled through the 2024/25 budget.

6. In 2021/22, income tax receipts across the UK increased markedly due to factors such as recovery from Covid-19 and increases in inflation. Total Scottish NSND income tax revenues rose by 14.9 per cent between 2020/21 and 2021/22, compared to an increase of 15.5 per cent in NSND income tax revenues across England and Northern Ireland. Between 2019/20 and 2020/21, Scottish income tax revenues rose by 1 per cent compared to a rise of 2 per cent across England and Northern Ireland.³

7. The report also covers HMRC's provisional estimate of Scottish income tax receipts for 2022/23. This provisional estimate does not affect the Scottish budget. The final outturn for 2022/23 is expected to be reported in summer 2024.

Audit and assurance

8. The C&AG made his ninth annual report to the Scottish Parliament on 19 January 2024. His report relates to 2022/23 and considers:

- HMRC's calculation of the 2021/22 income tax revenue attributable to Scotland and provides assurance on the correctness of the amounts brought to account
- HMRC's estimation of the 2022/23 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

³ [Scottish Income Tax Outturn Statistics: 2021 to 2022](#), HM Revenue & Customs, July 2023.

- 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 agreement between HMRC and the Scottish Government.

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
- 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 2022/23 Annual Report and Accounts included Scottish income tax outturn figures relating to the 2021/22 year. Scottish income tax in 2021/22 was £13.724 billion.⁴

13. For the 2022/23 tax year, HMRC provided a provisional estimate that Scottish income tax revenue will be £14.996 billion. HMRC will publish the final Scottish income tax outturn for 2022/23 in its 2023/24 accounts, and an adjustment will be made to the 2025/26 Scottish Budget. The impact of tax outturns on the Scottish budget is explained in further detail at [paragraphs 58-65](#) of this report.

2021/22 final outturn

14. The C&AG concludes that Scottish income tax revenue outturn for 2021/22 is fairly stated.

15. The 2021/22 outturn calculation of £13.724 billion is largely based on established tax liabilities, after the tax owed has been finalised and the taxpayer

⁴ Administration of Scottish income tax 2022-23, National Audit Office, January 2024.

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 £100 million (0.7 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 May 2022. The C&AG notes that this methodology has remained broadly the same since the prior year.

17. Both income tax receipts and the number of people paying tax has increased markedly in 2021/22, in Scotland and in the rest of the UK. The C&AG notes that in Scotland, the outturn for 2021-22 represents an increase of 14.9 per cent compared with 2020-21 (£13.724 billion compared to £11.948 billion). The outturn for non-savings, non-dividend income tax for the whole of the UK increased by 15.4 per cent in 2021-22. HMRC and the Scottish Fiscal Commission have pointed towards economic recovery from the pandemic and tight labour market conditions in a period of inflation as contributing factors.

18. The Scottish Fiscal Commission has reported⁵ on the reasons for an increase in the number of taxpayers in 2021/22, noting that,

“There was a 5.1 per cent increase in taxpayers in 2021-22 compared to 2020-21. This was unexpected as outturn statistics from HMRC show that the number of taxpayers in Scotland remained steady between 2016-17 and 2020-21. HMRC noted in their accompanying report⁶ that fiscal drag has resulted in the increases in the proportion of intermediate, higher, and top rate taxpayers in Scotland. There has also been a similar increase in England and Northern Ireland, with the number of taxpayers increasing by 5.2 per cent in 2021-22. This suggests that the reasons for the increase are UK-wide.”

19. [Fiscal drag](#) occurs when wages rise, due to factors such as inflation, while tax rates and bands remain unchanged. Some taxpayers will become newly liable to pay income tax or to move between tax bands and consequently pay more tax.

Fiscal drag is the extra tax received when people's wages increase but tax rates and bands remain unchanged.

20. The impact on the Scottish budget, explored later in this paper, relates to per capita growth in receipts relative to the rest of the UK under the terms of the Fiscal Framework. The percentage growth in tax receipts does not result in a similar level of growth in the Scottish budget. It is therefore important that the Scottish Government continues to monitor and consider the impact of relative economic and tax policy change in the rest of the UK to the Scottish budget. This is particularly important given that the Scottish

⁵ [Forecast Evaluation Report](#), Scottish Fiscal Commission, August 2023.

⁶ [Scottish Income Tax Outturn Statistics: 2021 to 2022](#), HM Revenue & Customs, July 2023.

taxpayer base has a greater proportion of basic rate taxpayers and fewer higher rate taxpayers compared to the rest of the UK, meaning factors such as fiscal drag may affect Scotland differently. This is likely to remain the case for future budget years, potentially influencing budget growth from future tax policy decisions.

The impact of Covid-19 on 2021/22 outturns

21. HMRC estimates the amounts that are still expected from 2021/22 but have not yet been collected. In any given year, some taxes that are due will never be paid. Estimated liabilities therefore includes a deduction for taxes that may never be collected.

22. Covid-19 has not resulted in any substantial change to the overall collectability deductions to the Scottish outturn compared to previous years. The overall estimate of uncollectable revenue deducted by HMRC from the 2021/22 outturn was £94 million. This is £3 million lower than the figure deducted from the 2020/21 outturn for uncollectable amounts, and £5 million greater than the 2019/20 outturn, which covers the pre-pandemic period.

2022/23 provisional estimate

23. [HMRC's provisional estimate](#) is for reporting purposes and does not affect the Scottish budget. The C&AG concludes that HMRC's approach to establishing the provisional estimate is reasonable.

24. 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 (2021/22) Scottish income tax outturns and adjusts its estimate accordingly. HMRC performs this calibration because, historically, actual tax outturns have been lower than the provisional estimates. The C&AG notes that the methodology is largely consistent with that used to calculate last year's 2021/22 estimate. However, the C&AG also outlines the continuing limitations described in previous reports in using SPI data.

25. HMRC identifies the key source of uncertainty in the 2022/23 provisional estimate as the accuracy with which it can identify the Scottish percentage share of UK NSND tax income. The C&AG notes that the estimated share that HMRC calculates is based on 2019/20 survey data. I understand that 2020/21 SPI data is available, but this has not been used to inform the 2022/23 estimate due to the impact of the pandemic on these figures.

26. The C&AG also notes that the outturn for 2021/22 was 3.2 per cent higher than HMRC had originally estimated, compared to the years between 2018-19 and 2020-21 where the outturn was approximately 1 per cent from HMRC's estimates.

27. HMRC estimates that Scottish income tax revenue will grow at a slightly higher rate than the UK overall in 2022/23. HMRC took account of this as part of its calibration adjustment.

HMRC's estimated outturn for 2022/23 does not affect the Scottish budget.

28. The C&AG reports that the 2022/23 Scottish income tax estimate represents an increase of £1,273 million (9.3 per cent) against the 2021/22 outturn, compared to an 8.9 per cent increase for the UK overall against the 2021/22 outturn. The C&AG notes that these increases reflect continued inflationary rises in earnings, together with the freezing of the higher and top rates of income tax in Scotland and all income tax bands and thresholds in the rest of the UK, moving some taxpayers into higher tax brackets.

29. The C&AG also concludes that the impact of other external factors such as high interest rates and inflation, wage growth and high and volatile energy prices increased the level of uncertainty in HMRC's estimate of Scottish income tax revenue.

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

31. I note that the Scottish Fiscal Commission's most recent forecast for 2022/23 Scottish income tax receipts is £15.309 billion which is around two per cent higher than HMRC's provisional estimate.

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

32. The C&AG concludes that 'HMRC has adequate rules and procedures in place to assess and collect Scottish income tax and that these are being complied with.'

33. The administration of Scottish income tax is governed by a Service Level Agreement (SLA) between HMRC and the Scottish Government.⁷ 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.⁸

34. 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. From 2023/24

⁷ HM Revenue & Customs, Service level agreement for operation of Scottish Income Tax by HMRC, 30 September 2022.

⁸ [Scottish Income Tax HMRC Annual Report 2022](#), HMRC, February 2023.

onwards, the Scottish Government and HMRC agreed to publish the minutes of the Scottish Income Tax Board.

35. The publication of the Scottish Income Tax Board minutes is an important step towards greater transparency in decision-making. Given ongoing economic uncertainty and volatility and increased divergence between 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

36. 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.

37. 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 main source of assurance over HMRC's address information and is part of a wider suite of assurance activity detailed in Figure 9 of the C&AG's report.

38. The C&AG has reported that third-party data exercises continue to be run every two years. In my view, 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. I am aware that the Scottish Income Tax Board agreed in July 2023 to review the frequency of the third-party data clash scan following the conclusion of the 2023 to 2024 process.

39. The most recent exercise was completed in August 2023. The results of this exercise became available in December 2023, and the HMRC has not yet assessed reasons for trends in data.

40. While there are 2.7 million NSND Scottish taxpayers, HMRC holds 5.3 million taxpayer records, excluding duplicates, temporary numbers, deceased taxpayers and inactive records. The C&AG reports that overall, the residency status of taxpayers for 72.9 per cent of these records could be corroborated to third-party data with a Scottish address. This is a slight increase from 72.2 per cent of records corroborated in the previous third-party data exercise in 2021. The C&AG notes that this remains lower than the 78.7 per cent matched in HMRC's 2019 exercise, meaning there remains an increased reliance on internal HMRC records and other assurance activity compared to 2019. The C&AG notes that HMRC identified the impact of data protection regulations on third-party data sets, a higher death-rate due to the Covid-19 pandemic, the inclusion of 16- to 18-year-olds on the electoral roll and an increase in people changing address as potential reasons for records not matched to third-party data.

41. 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 2022/23.

Compliance risks

42. 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.

43. The C&AG reports that HMRC generated an estimated additional £380 million in Scottish income tax through its compliance activities in 2021/22 through generating additional revenues or preventing revenue losses. Scotland's share of the estimated revenue lost in 2020/21 (the latest year for which data is available) from risks identified in the SPR, such as tax evasion and not declaring income, is £1.1 billion.

44. 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.

45. 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. The C&AG concludes that, with tax policy diverging further from 2023/24 there is a risk that HMRC's assessment may not be sustainable in the longer term.

46. The C&AG also reports that HMRC's consideration of compliance risk typically looks at tax liabilities from two years prior. Any compliance risk arising from further divergence in tax policy between Scotland and the rest of the UK from 2023/24 is therefore unlikely to be considered until at least 2025/26.

47. This can lead to two separate risks for the Scottish Government to manage. Firstly, the delay means that the Scottish Government are not able to make tax policy decisions on the most up to date consideration of compliance risk. Secondly, the delay means that by the time any change in compliance risk is identified, it is too late to reflect in the confirmed outturn for the year in question.

48. For example, the outturn for 2023/24 Scottish NSND income tax will be known in summer 2025, with the adjustment to the Scottish budget then being made to the 2026/27 budget. Therefore, reconciliations to the 2026/27 budget would be made before compliance risks arising from further tax divergence in 2023/24 are fully known.

49. 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.

50. Each year, HMRC also monitors cross-border migration trends to identify potential instances of taxpayers erroneously changing their address to obtain a tax advantage. The C&AG reports that for 2022/23 states HMRC encountered difficulties with importing land and property transaction data into its systems. This has caused a delay in HMRC's plans for analysing these data, although HMRC expects the analysis to be complete by January 2024.

51. For 2023-24, the Scottish Government has commissioned HMRC to use more sources of information to corroborate the validity of taxpayers' movements where land and property transaction data are not suitable. This information could include electoral roll, credit reference and other available third-party information. This is intended to help establish a more reliable baseline of cross-border movements against which to monitor the impact of increased divergence in income tax rates from 2023/24.

52. In my view, the Scottish Government should regularly consider the costs and benefits of additional compliance activity in Scotland. We are aware that the Scottish Income Tax Board in July 2023 commissioned an update to the Compliance Plan to further consider how HMRC's Scottish Income Tax compliance activity fits into its wider work to administer Scottish income tax.

Taxpayer behaviour

53. Taxpayers may respond to divergences in tax policy by changing their behaviour. Behavioural responses can cover a wide range of taxpayers' responses to policy changes, including:

- **Economic responses:** seeking work or increasing the number of hours worked or vice versa.
- **Cross-border mobility:** taxes could also affect migration, both into and out of Scotland.
- **Tax planning or avoidance:** shifting income into a more tax-efficient source, such as dividends; or artificially reducing one's tax liability.
- **Evasion:** where there is a deliberate (and illegal) attempt not to pay the tax which is due.

54. In December 2021, HMRC published an analysis of Scottish taxpayer liabilities and behaviour over time. 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. The Scottish Government reflected the findings in relation to Scottish taxpayers in its policy evaluation of Scottish income tax, also published in December 2021.

55. The C&AG has reported that HMRC has now produced an initial version of a dataset to enable a series of analyses, including examining the historical levels of migration across the Scottish and Welsh borders by age and income level. HMRC expects 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.

56. In my view, 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. In my view, results of this first dataset analysis should be made publicly available as soon as is practicable.

The accuracy and fairness of the administrative expenses

57. 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 2023) was accurate and fair in the context of the agreement between HMRC and the Scottish Government’. HMRC invoiced the Scottish Government for £0.6 million of costs relating to the administration of Scottish income tax in 2022/23 (£0.6 million in 2021/22).

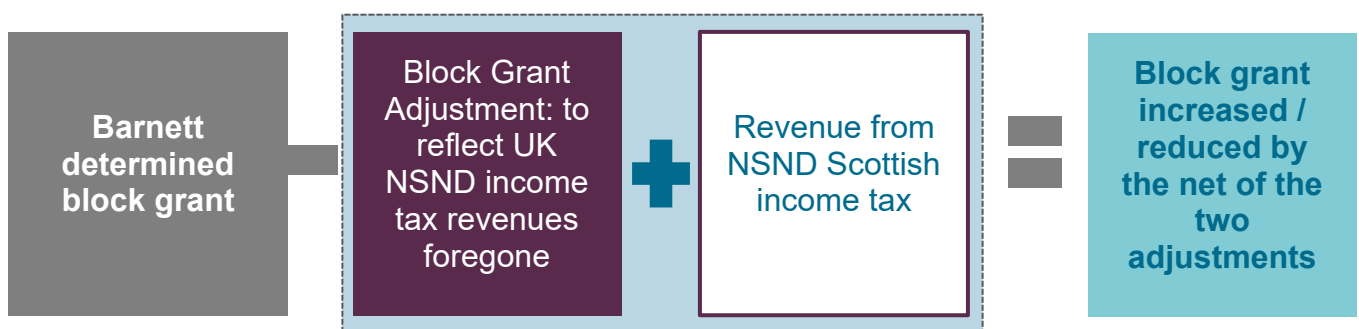
Impact of tax outturns on the Scottish budget

58. 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).

59. 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

60. 2021/22 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.

61. The reconciliation resulting from 2021/22 outturn figures is a budget decrease of £390 million. This is the largest adjustment to the budget resulting from the budget reconciliation to date. This will be made through the 2024/25 Scottish budget. As part of the updated Fiscal Framework Review earlier in 2023, the reserve drawdown limits of £250 million for resource and £100 million for capital have been abolished. Resource borrowing limits have also been revised up to £600 million. Therefore, the Scottish Government could choose to cover this downward adjustment by using reserves or borrowing, or a combination of the two.

62. Forecasts originally used for the 2021/22 Scottish budget increased the budget by £475 million, the net difference between forecast tax foregone by HM Treasury and forecast Scottish income tax receipts. Outturns show that the actual increase was £85 million, £390 million less than the forecasted difference ([Exhibit 2](#)). While the Scottish Income Tax outturn was greater than forecasted by the SFC, the corresponding block grant adjustment was relatively higher, due to greater tax receipts in the rest of the UK. The SFC notes that it had to make several assumptions around the outlook for Covid-19 and its effects on the economy and tax base when setting its forecasts. For example, it expected the furlough scheme to end on 30 April 2021, but it was subsequently extended until 30 September 2021 which supported employment as the economy re-opened. It also notes that the Scottish economy itself was more resilient than was expected.

63. The SFC estimates that differential income tax policies implemented since 2017/18 have raised up to an additional £750 million from Scottish taxpayers in 2021/22, when compared with matching income tax policy in the rest of the UK. The SFC notes that relatively weaker economic performance alongside differences in the income distribution have largely offset this.

64. Because the 2021/22 Scottish Budget was set in December 2020 before the UK Budget in March 2021, the Scottish Government was able to choose after the UK budget whether to set its final budget based on the provisional BGA produced by the OBR as part of the UK Spending Review in November 2020, or to use the updated BGA based on the OBR's March 2021 forecasts. The Scottish Government chose to use the November 2020 BGA for its final budget. This gave a more favourable budget in the short term, but gave an increased risk of a negative reconciliation being required through the 2024/25 budget.

65. Had the Scottish Government used the March 2021 BGA forecasts in its 2021/22 budget instead, then this would have resulted in a lower budget decrease through the 2024/25 Scottish budget, of £342 million ([Exhibit 2](#)). I note however, that this is less than the £712 million negative reconciliation forecast by the Scottish Fiscal Commission in May 2023, which was factored into the Scottish Government's Medium-Term Financial Strategy (MTFS). The MTFS expects positive reconciliations in future years.

Exhibit 2**How the Scottish Income Tax outturn relates to the 2024/25 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 2021/22 budget	-11,788	12,263	475
Final outturn	-13,639	13,724	85
Reconciliation required through the 2024/25 budget			-390
Alternative BGA forecast option not used for the 2021/22 budget	-11,836	12,263	427
Final outturn	-13,639	13,724	85
Reconciliation to the 2024/25 budget that would have resulted from application of alternative BGA forecast			-342

Source: Audit Scotland, based on [Scotland's Economic and Fiscal Forecasts](#), Scottish Fiscal Commission, December 2023

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