

### Summary and recommendations

The review has considered several options for change, as the means of achieving the review's objectives, rather than ends in their own right (and the objectives will in turn contribute to achieving better outcomes, such as funding better health and education for citizens). The analysis is focussed on three leading options:

- *status quo plus*, under which organisational change would be limited to that necessary to implement the recommendations on policy and accountability;
- creating a single new department, which integrates Customs and the Revenue; and
- strategic alignment, under which a strategic board would be formed to promote the long-term alignment of the existing departments.

The review assesses that creating a new department offers benefits greater than the other options, with improvements to:

- customer service and compliance costs, through more coherent tax policies and the provision of a unified tax service for all customers;
- effectiveness, through alignment of strategies, a coherent approach to information, new approaches to audit, and flexible resource allocation. By better ensuring that the right tax is paid by the right taxpayers (or credit received), fairness would also be enhanced; and
- efficiency, through economies of scale, particularly in transactional processes (although benefits to customers and effectiveness are likely to outweigh efficiency gains).

These gains are dependent upon dealing with shared customers – mainly businesses – in an integrated way, and would not be achieved with the *status quo plus* option. Their achievement through strategic alignment would be uncertain; the roles of Ministers, the strategic board and the management of the revenue departments could be difficult to set out clearly, creating accountability difficulties.

All changes involve costs. Given the scale and nature of the departments, there would be significant short-term costs with the creation of a new department. It is also necessary to consider opportunity costs, particularly for the *status quo plus* option, where the value of lost opportunities could be considerable.

Risks are a more significant consideration than direct financial costs. These include risks to 'business as usual' (including revenue collection) and the disruption of projects already planned. However, other countries that have undertaken the integration of direct and indirect tax administrations have found that revenue has increased rather than fallen as a result of integration, including in the short term. The review assesses that the potential risks can be mitigated by strong management and good planning, and are outweighed by the potential long-term benefits of integration.

The review therefore recommends that:

- a new single revenue department should be established, integrating Customs and the Revenue.

(continued overleaf)

**Summary and recommendations (continued)**

The details of the implementation of this recommendation would be a matter for the management of the new department, but subject to this, the management should:

- create a new culture and identity for the department, building on the cultures of Customs and the Revenue;
- expand career opportunities for staff, developing strong career paths to provide experience across the new department, with frequent interchange between the new department and the Treasury;
- structure the new department as far as possible around customers and functions rather than taxes, so that customer needs can be better met and compliance improved, for example by establishing an integrated large business office, and more specialised service to small businesses;
- develop a better focussed PSA target on customer service and compliance costs for the 2004 Spending Review, supported by work to develop understanding of compliance costs;
- develop a better focussed PSA target on compliance across the tax system for the 2004 Spending Review, supported by work to develop understanding of the tax gap and other compliance measures;
- generate significant cost savings through improved efficiency, in line with the proposals of this review and that of Sir Peter Gershon; and
- look to identify economies of scale and scope by developing new national services, and reviewing the local office network, including with other departments.

**INTRODUCTION**

**3.1** This Chapter considers how best to improve the organisational arrangements for tax administration. Organisational changes are the means of achieving the review's objectives, rather than ends in themselves. The objectives involve, for example, better collection of tax, which contribute to better financed public services, such as schools and hospitals, in turn contributing to outcomes for citizens, such as better education and health.

**3.2** As established in Chapter 2, there is a significant business customer overlap between the revenue departments and a commonality of functions in their revenue activities. There is also scope for improvement in customer service and in tax collection. As a result, suggestions for organisational changes, including integration of the departments, are often made. If starting from scratch there would be little to recommend the current arrangements. This Chapter explores whether the costs and risks of change are outweighed by the benefits.

**3.3** A particular focus of the review has been on those who deal with both Customs and the Revenue: the business customers. However, the review also takes into account the needs of the wider customer bases of the two departments, personal taxpayers and tax credit claimants in particular, and the need to improve customer service and reduce compliance costs for all of the revenue departments' customers.

**3.4** This Chapter assesses several options for changing the organisational arrangements for tax administration against the objectives set out in Chapter 1. Three options have clear disadvantages, and are considered only briefly to illustrate points about more promising options:

- creation of separate business and personal tax departments;
- reallocation of tax responsibilities between the departments to reduce customer overlap (e.g. the transfer of VAT to the Revenue or of Corporation Tax to Customs); and
- partial merger, integrating some functions but retaining separate lines of management for others.

**3.5** Three more promising options are considered in more detail:

- *status quo* plus (under which organisational change would be limited to implementing the policy and accountability recommendations of this review);
- the creation of a new revenue department, which integrates Customs and the Revenue; and
- a more robust closer working model with limited changes to organisational boundaries, but with a strategic board to provide impetus ('strategic alignment').

**3.6** The framework within which these options are analysed has four elements:

- establishing a case for change through analysis of the departments' functions, international and domestic comparisons, and the closer working experience;
- identifying where improvements can be made in terms of the review's objectives;
- providing an overview of transitional costs and risks that would need to be addressed in any change process; and
- assessing the three lead options.

## THE CASE FOR CHANGE

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**3.7** There are four strands to the case for change, which are considered below:

- international evidence suggests that organisation by customer and function is more effective and better at meeting customer needs than organisation by tax type;
- in the UK, there have been significant benefits from reorganising DWP around its customers;
- closer working between the revenue departments since 1994 has not achieved the benefits envisaged for it; and
- an analysis of the revenue departments' functions reveals opportunities to realise benefits from reorganisation.

## International evidence

**Best practice 3.8** The IMF<sup>1</sup> and the OECD<sup>2</sup> stress the advantages of organising tax departments by function or customer rather than by tax type, and the division of tax administration into direct (the Revenue) and indirect (Customs) taxes in the UK is often presented as a negative case study. This is the starting point for the functional analysis set out later in the Chapter. Almost all developed countries have a unified tax administration at the national level,<sup>3</sup> and outside the OECD, only Israel and Malawi share the UK's structure of tax administration (and Israel is planning to create a single tax administration).<sup>4</sup> A survey of OECD member tax administrations identified the trends set out in Table 3.1. To buttress the existing evidence the review has undertaken a series of country visits led by Sir Nick Montagu. These have produced a series of up to date country case studies, summarised in Annex A.

**Table 3.1: trends in tax administration**

From	>	To
Taxpayer	>	Client/customer
Segmented service	>	Integrated one-stop shop
Paper communications	>	Electronic
Cheques and cash	>	Electronic funds transfer
Manual responses	>	Automated responses
Reactive programmes	>	Proactive programmes
Assistance	>	Self help and education

Source: Hamilton, S. *Putting the Client First: The Emerging Copernican Revolution of Tax Administration*, *Tax Notes International*, 10th February 2003(OECD).

**Benefits of a customer focus...** **3.9** The IMF argues that tax administration is most effective when it takes a holistic view of business accounts rather than focussing only on the requirements of direct or indirect taxes. In particular, the IMF<sup>5</sup> recommends that specialised large taxpayer units be set up to administer all the major taxes with a view to:

- securing tax revenue (by improving compliance);
- improving the effectiveness of audit;
- improving the management of tax arrears; and
- providing better services to taxpayers.

<sup>1</sup> See for example Vehorn, C.L., and Brondolo, J., *Organizational Options for Tax Administration*, International Bureau of Fiscal Documentation November 1999 (IMF).

<sup>2</sup> See for example Hamilton, S., *Putting the Client First: The Emerging Copernican Revolution of Tax Administration*, *Tax Notes International*, 10th February 2003 (OECD).

<sup>3</sup> 27 out of 30 OECD countries have unified national administrations. The exceptions are the UK, Switzerland, where direct taxes are largely decentralised to the cantonal level, and Luxembourg. Source: OECD.

<sup>4</sup> Israel plans to integrate its departments in July. Source: review team interview.

<sup>5</sup> Baer, K. et al, *Improving Large Taxpayers' Compliance: A Review of Country Experience*, IMF, 2002

**3.10** In addition, a whole customer view<sup>6</sup> of micro and small businesses would allow strategic consideration of a range of policy, information and implementation tools that could reduce compliance costs and increase economic activity. These might include:

- using a single web-based portal for business advice with telephone support (developing the business.gov programme); and/or
- the simplification of data collection and business identifiers that would help to simplify tax processes for small business.

**...and  
limitations of  
a tax focus**

**3.11** The obverse of this is that administrations that are organised by tax type (as in the UK) miss the benefits of customer-focussed organisations.<sup>7</sup> Tax-based organisations potentially have higher administrative costs and lower productivity because functions are duplicated across the departments. The tax-based structure also makes joint compliance programmes more difficult to implement.

**3.12** At the same time, the difficulties of quantifying the benefits of a shift to a customer-based approach are widely recognised. Those countries that have made changes considered in this review have tended to base decisions on qualitative as well as quantitative arguments.

**International  
comparisons**

**3.13** International comparisons of tax administrations are difficult, given the particular features of tax systems that both influence who the customers are and what they and revenue administrations have to do. For example, in the UK there is:

- a heavy reliance on collection at source – PAYE, savings taxation – and consequently a limited requirement for tax returns;
- multi-stage collection of the main indirect tax, VAT;
- self-assessment for some taxes;
- a different timetable for the two main business taxes, with VAT paid a quarter in arrears, and Corporation Tax, paid nine months after the profit is made (or by quarterly instalment payments in the case of large companies); and
- the use of the tax system to provide incentives and other policies – e.g. research and development credits, and zero-rating of VAT.

**3.14** Other countries are different in some or all of these areas, and these differences in administrative approaches, along with differences in tax rates and bases, help explain why quantitative international comparisons are beset with difficulties. With these qualifications in mind, the evidence suggests that the UK is roughly average among developed countries. A French study in 1999 suggested that the UK is somewhere in the middle of the ‘league’ when considering the effectiveness and efficiency of tax administrations in developed countries.<sup>8</sup> This conclusion is consistent with work by the OECD and with the review’s study of other tax administrations. For example, France and Germany have proportionately more staff, and Australia and Canada proportionately significantly fewer staff than the UK for each unit of revenue raised.

<sup>6</sup> The issue of developing a ‘whole customer view’ is explored further in Chapter 4.

<sup>7</sup> See for example Vehorn, C.L., and Brondolo, J., *Organizational Options for Tax Administration*, International Bureau of Fiscal Documentation November 1999.

<sup>8</sup> *Mission d’analyse comparative des administrations fiscales: Rapport de synthèse*, Inspection Generale des Finances No. 98-M-041-11, March 1999

**3.15** Other things being equal, there are reasons to think that the UK should be better at collecting taxes than most OECD countries, namely that it:

- has a relatively law abiding culture, with long-established, legitimate political institutions, suggesting that UK taxpayers are relatively willing to comply with their obligations; and
- is a unitary state, avoiding some of the duplication of federal administrations (e.g. Germany).

**3.16** The review has examined in detail the experience of Canada and Australia. Canada (see Boxes 3.1 and 3.5 and Annex A) has been a focus of interest for others who have investigated the case for change, including the Treasury Select Committee.<sup>9</sup> Of particular note is the significantly increased productivity of compliance work, resulting primarily from integrating audit for micro and small businesses.<sup>10</sup>

**Box 3.1: the Canadian experience: part I<sup>11</sup>**

In October 1992, a decision was taken to integrate the Customs and Revenue equivalents in Canada. In May 1994 legislation for an integrated tax administration was passed.

Like Customs and the Revenue in the UK, before 1992 the two Canadian organisations had a number of similarities:

- they dealt with similar business customers, many of which paid taxes, payroll taxes, excise and customs duties;
- they carried out many of the same functions, including assessing and collecting taxes, maintaining customer accounts, responding to enquiries;
- they were both regulatory bodies carrying out similar enforcement activities, such as auditing businesses' books and records to verify declarations and detect fraud;
- as government departments they had similar internal systems, policies and procedures; and
- the employees of both organisations had many of the same skills.

However, like their UK equivalents, the two organisations operated in different timeframes, with Customs working in real time and the Revenue operating retrospectively.

The integration of the two departments was undertaken in order to:

- eliminate overlap and duplication and so achieve efficiencies and improve service;
- enhance fairness and consistency for customers and at the same time better target compliance;
- reduce the burden and cost of compliance for customers in meeting their tax obligations;

<sup>9</sup> See Treasury Select Committee - *Second Report: HM Customs & Excise*, HC 53 Session 1999-2000, 8<sup>th</sup> February 2000, available at [www.publications.parliament.uk](http://www.publications.parliament.uk)

<sup>10</sup> Source: Review team interview.

<sup>11</sup> See Baker, W. *Organizational Aspects and Human Resources Problems in an Integrated Organization*, Lecture for the CIAT Technical Conference, Madrid 1997

- improve coordination across government; and
- provide challenging jobs and career opportunities for staff.

**3.17** The Australian experience in introducing General Sales Tax (GST) has provided some quantitative evidence. It demonstrates the positive impact of the introduction of a VAT on the existing direct taxes, where revenues are estimated to have risen by roughly 1% as a result (see Box 3.4). Introduction of a new tax created opportunities to make other changes, such as introducing a business identifier, which improved tax administration. Such changes might or might not also be included in a programme of organisational change. But the case studies do serve to illustrate that there are potentially significant effectiveness benefits to be gained by adopting a different approach to compliance work.

**3.18** Overall, from the international evidence, the potential benefits of organisational change to bring the revenue departments closer together relate to:

- lower compliance costs and better service for (and more effective tax collection from) 1.7 million shared business customers by providing the opportunity to organise around customers; and
- synergies between the revenue departments' functions and similarities in the skills of their staff.

## Department for Work and Pensions (DWP)

**3.19** The benefits of designing organisations around customers are not of course confined to tax administration. The trend in private sector service organisations is to organise around customers. The Government recognised the need to take a holistic view of working age customers when employment and benefits were integrated with the creation of DWP and its reorganisation into customer focussed agencies (see Box 3.2). This has realised substantial benefits in effectiveness and customer service, not least through providing one-stop services to people of working age and pensioners.

**3.20** These organisational changes were designed to improve the customer experience and provide a coherent mechanism for implementing Government policy. The search for efficiency savings did not drive this change, but economies of scale can be realised in most mergers. In the DWP case roughly 5% efficiency savings were achieved each year during the initial stages of implementation. The merger allowed DWP to achieve efficiencies by rationalising support services in the new organisation. This, along with a wider programme of change and modernisation, has permitted a planned staffing reduction of 11% by the end of March 2006, from the start up levels in 2002-03.<sup>12</sup> In the private sector it is often these potential efficiency savings that provide the motivation for mergers.

<sup>12</sup> Source: PESA data, available at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk) or [www.statistics.gov.uk](http://www.statistics.gov.uk).

**Box 3.2: DWP: organising around customers**

DWP was created in 2001, bringing together policy and operations on employment (from the former Department for Education and Employment) pensions, and benefits. This led to the establishment in April 2002 of:

- Jobcentre Plus through the integration of the Employment Service and the Working Age parts of the Benefits Agency (announced in 2000, with the introduction of joint offices started in 2002, due to be completed in 2006); and
- the Pensions Service: taking over responsibility from the Benefits Agency for Retirement Pension, Minimum Income Guarantee, and Winter Fuel Payments. These will be provided primarily through 29 Pension Centres.

In the case of people of working age, the Government is interested in the interaction of the agency with the citizen as a way of changing behaviour (encouraging people into work). Putting benefits and job seeking processes on the same site has allowed more effective conditionality to be introduced into the granting of benefits.

The organisation of DWP into customer-focussed agencies reflects the Government's differing objectives with regard to those of working age and pensioners. It also helps to connect policy to operations, because operational staff can have a clear line of sight to the policy objectives relating to the customer group that they are working with (which are more focussed than the objectives of the department as a whole).

Organising around customer groups has allowed the establishment of targets that provide good incentives to managers in Jobcentre Plus to achieve policy objectives. For example, if a Jobcentre Plus office helps a jobseeker in certain categories (e.g. lone parent, recipient of primary benefits) to find work, the office receives 12 'points' towards its target. If it helps a jobseeker in a category who is likely to be more able to find work on his or her own, the office only receives one 'point.' This system establishes incentives to devote most resources to those who need them most.

## Closer working since 1994

**3.21** The revenue departments work closely with a number of other Government departments – for example, the Revenue with DWP for individuals in work and paying tax and receiving tax credits. There is however, a particularly strong overlap between the revenue departments themselves in the area of business customers. This overlap, the limitations of the UK's tax-based approach, and the potential benefits of greater integration were identified by the internal review of the Revenue and Customs, completed in 1994. That review led to the establishment of the closer working programme between the revenue departments.

**3.22** Many of the outcomes sought from closer working were similar to those of this review, including:

- the development of central taxpayer records containing information across different tax regimes;
- improved coherence in processing returns and payments;
- a joint approach to work on compliance;
- coordinated customer service; and

- integrated collection and enforcement in relation to debt.

**3.23** Recognising the slow progress made in attaining these outcomes, in 2000, closer working was refocussed onto six main projects relating to business (as well as ongoing local liaison):<sup>13</sup>

- Large Business Joint Team trials;
- Joint Computer Audit Project;
- Joint Shadow Economy Teams (JoSETs);
- the Closer Working Intelligence Project (now Closer Working Intelligence and Data Sharing);
- Business Support and Advice Initiative; and
- Integrated Debt Management.

**Promising but limited results**

**3.24** Closer working has produced promising but limited results. On the one hand, it has demonstrated the benefits of closer working and information sharing, albeit in a limited range of projects, and often requiring work-arounds to make progress. JoSETs for example, have produced additional revenue for Customs, the Revenue and DWP by bringing many new taxpayers into the legitimate economy (see Chapter 4). Large Business Joint Team trials have also produced benefits for customers and the departments (see Box 3.3), picked up in the new compliance process developed last year in the Revenue's LBO. On the other hand, the significant potential seen for closer working in the mid-1990s has not been realised. The departments themselves agree that a significant change is required to realise this potential.

**Box 3.3: Large Business Joint Team trials<sup>14</sup>**

Large Business Joint Team trials have been one of the priority areas identified under closer working between the revenue departments. The trials aimed to reduce compliance costs, improve compliance, and contribute to the development of tax policy and legislation relating to large businesses. They began on 1<sup>st</sup> April 2001, and covered fourteen large business groups in the finance, telecommunications, pharmaceuticals and food retailing sectors. These groups agreed to participate voluntarily, as there is no legislation in place for joint working. The trials have led to improvements for customers and the departments, although there have been significant obstacles for the Teams to overcome.

Businesses participating had only to provide information once to the two departments. Joint visits to sites have meant that businesses have only had to provide access to auditors on one occasion. Businesses were not subject to valuation audits by Customs for Customs Duty purposes, as information provided to the Revenue and shared with Customs provided assurance.

**(continued overleaf)**

<sup>13</sup> Further information on the closer working programme is available at [www.inlandrevenue.gov.uk](http://www.inlandrevenue.gov.uk), [www.hmce.gov.uk](http://www.hmce.gov.uk), and in the TSC *Second Report: HM Customs & Excise*, HC 53 Session 1999-2000, 8<sup>th</sup> February 2000, available at [www.publications.parliament.uk](http://www.publications.parliament.uk)

<sup>14</sup> Source: the Revenue.

**Box 3.3: Large Business Joint Team trials (continued)**

Information exchange between the departments has allowed discrepancies to be identified in the way the same items have been described to the departments. The trial has also helped with businesses having difficulty paying their taxes. For example, when a business was due to receive a repayment from one department, but at the same time was delaying payment to the other, the departments could co-ordinate their response.

Overall, over £11m additional revenue was raised in the first two years of the trial, and the staff concerned believe that significant additional revenue will be collected in the longer term as a result of issues identified during the trials. Even with the absence of a legal basis (and no seriously non-compliant business is likely to volunteer for such an exercise) the trials produced significant benefits, albeit with high start up costs for the departments.

**Obstacles 3.25** The obstacles to achieving these benefits have included:

- Customs and the Revenue have (naturally enough as separate departments) different strategic and operational priorities and targets, as well as separate allocation of resources. This, combined with cultural and management differences, sometimes created tensions around closer working projects. For example, the time taken to establish a joint team can be a disincentive if there is a more immediate need for action within one department than the other; or priorities may change over the life of a project, resulting in staff being diverted to other activity. Those involved consider these institutional differences to have been the most significant obstacle to closer working;
- following from these different targets and priorities, activities that did not offer a visible return on investment for both departments, or even where gains were substantially less for one than the other, were less likely to be pursued, even if this could have brought benefits to the exchequer as a whole;
- closer working teams have needed to design their approaches around legal differences in the tax framework, as well as the laws governing information sharing (see Chapter 4). For example, direct access to bulk data has required a member of staff from the relevant department to act as ‘gatekeeper’;
- practical difficulties have emerged, particularly for joint team working such as the JoSETs, for instance owing to the different IT suppliers with different approaches and resources; and
- the data required to support projects have sometimes been of poor quality and/or difficult to locate and ‘match’ across the taxes. As closer working has had limited influence on the departments’ wider agendas, it has been difficult to address these crosscutting issues (see Chapter 4).

**3.26** Any organisational change should address these obstacles. The lessons from closer working have underpinned the functional analysis of the revenue departments, summarised below.

## Functional analysis

**3.27** In keeping with best practice, as recommended by the IMF and the OECD, the review analysed the functions of the revenue departments to compare them, and to consider the scope for changes to meet the review's objectives.<sup>15</sup>

**3.28** The main revenue-related activities of Customs and the Revenue follow a similar pattern. Payment and information are collected from customers. Information comes into the departments through tax returns, applications for registration, requests for advice and other customer contact. The customer profile is updated and, where risks are identified, one of a range of actions may be triggered: a visit or desk-based audit; an offer of education or advice; other compliance activity (e.g. written reminders); or debt management action. Each of these activities is likely to generate further information to update the customer profile and so enable risks to be reassessed. This process is represented in Chart 3.1. Seven key elements of the functional model are set out below.

### Knowledge and information

**3.29** Knowledge and information sit at the heart of the model, and are a key driver of the effectiveness of the other functions, as set out in Chapter 4. This involves data management, analysis and modelling, and information services such as knowledge management programmes and IT. It represents a collection of processes and activities by which information is used to inform risk assessment and decision-making. Around 1% of Revenue and 9% of Customs staff work directly in this area, although in a sense all staff are involved in some way.

### Data capture and processing

**3.30** Data capture and processing involves collecting data from customers and third parties, which is entered onto departmental systems, validated and corrected. Validation includes arithmetic and other checks, but it does not include audit-based verification. Data may be basic customer information (e.g. name, address) or tax-related information (e.g. VAT or self-assessment returns). Reflecting the larger number of customers and the data needs they generate, around 53% of Revenue and 9% of Customs staff work on this function.

### Receipts and payments

**3.31** Receipts and payments entails receiving money from taxpayers, making payments to taxpayers and claimants and updating customer accounts accordingly. This includes banking the money received – an area that is being considered in detail by the Chancellor's Departments Banking Review (see Annex C). Around 3% of Revenue and 4% of Customs staff work on this function.

### Audit, investigation and disruption

**3.32** Audit, investigation, and disruption involve staff using tax-specific expertise to make judgements. Audit involves those processes to check the validity of tax declarations, ensure compliance with regulations, and adjust customer accounts accordingly. As set out in Chapter 2, customers are assessed according to where they are found on the compliance spectrum. Audit work may be desk-based or involve visits to customers, and includes work done to identify and tackle avoidance schemes through litigation. In the case of Customs, it excludes work initiated because fraudulent activity is suspected. Investigation and disruption involves investigating and resolving revenue frauds, and developing strategies to diminish the profitability of such activity, as distinct from Customs' non-fiscal law and enforcement activities. Around 18% of Revenue and 46% of Customs staff work on this function.

<sup>15</sup> See also Chapter 2 and Annex B. A functional approach to analysis should be distinguished from the IMF and OECD's recommendation that tax administration should be primarily organised around customers.

**Education and advice** 3.33 Education and advice encompasses a mixture of transactional and judgement based work to help customers understand their obligations and rights. It includes both proactive and reactive processes such as business open days, leaflets, advertising, outbound telephone campaigns, and (increasingly) the provision of advice via contact centres and the Internet. Around 8% of Revenue and 5% of Customs staff work on this function.

**Debt management** 3.34 Debt management involves ensuring that tax due is received on time and making arrangements for settling debts that have arisen. It includes telephone and written reminders, time-to-pay arrangements for viable businesses with cash flow difficulties, and more robust debt recovery action where necessary. Around 8% of Revenue and 5% of Customs staff work on this function.

**Chart 3.1: revenue departments by function**



**Policy** 3.35 Although policy involves comparatively few staff, it provides the strategic direction for the other functions. Policy here refers to policy strategy and development as well as maintenance, and is the focus of Chapter 5. Policy is the one functional area where the Treasury plays a direct role. Just over 1% of the staff in the three departments work on policy, with more than 90% of these in the revenue departments.

**Support services 3.36** The final important area is support services, including human resources, legal services, asset management, finance, technology, and contract management and procurement. Around 11% of Revenue and 23% of Customs staff work on these areas.<sup>16</sup>

**3.37** The functional approach, while high level, makes it possible to compare, contrast, and identify potential room for improvement if the departments were either to work together differently or if the function were merged.

**Transactional activities 3.38** A number of the functions are transactional. They depend on activities where effectiveness is determined largely by speed, accuracy and technical expertise, and where the legal basis is more activity-specific than tax or customer specific. These functions tend to have clear comparators in the private sector:

- data capture and processing;
- receipts and payments;
- elements of education and advice, such as basic call centre operations and Internet self-service; and
- debt recovery.

**3.39** For these functions, there are strong similarities in skills and infrastructure requirements across the departments. Integration or different ways of working together would produce benefits for customers and efficiencies, but only limited effectiveness gains. Transactional functions are a focus of the Gershon review.

**Compliance activities 3.40** Other functions are associated more strongly with the nature of the tax type or the customer. Education and advice (other than basic call centre operations and Internet self-service), audit and, investigation, and disruption have a direct effect on taxpayer compliance. Much (although not all) of the activity under these functions relies on similar skill sets and the effective use of information. Improvements from integration or better coordination would produce mainly effectiveness or customer benefits, and efficiency gains would be limited.

## SUMMARY OF POTENTIAL BENEFITS

### Customer benefits

**3.41** Customers could see a real benefit from joint planning and activity of both transactional and compliance activities. As noted in Chapter 2, according to customer surveys conducted by the departments, they have high overall levels of customer satisfaction, particularly in areas like large businesses, in line with the message from informal discussions undertaken for the review. However, there are issues across all customer groups where the departments could do more to support compliant behaviour. The areas where customers are less satisfied are remarkably similar across the departments and better coordination in responding to these could achieve a better service.

**3.42** Benefits for business customers, many of which are related to the effectiveness benefits outlined above, could be achieved by using the information provided by customers to better understand their needs. This would assist in developing more

<sup>16</sup> The figure for Customs includes staff who support law enforcement, who are otherwise not factored into the calculations of staff numbers.

customer-focussed policies and designing more coherent delivery mechanisms, leading to reduced costs for compliant businesses. Overall, compliant businesses could expect to benefit from fewer interventions by the revenue departments, helping to reduce compliance costs. Other benefits could include:

- well signposted access to on-line tax information, with simplified and consistent guidance;
- streamlined access to telephone advice, removing the need for businesses to understand departmental structures before they can access the support they need;
- where possible - mainly for small businesses - integrated audits by the revenue departments, and for larger businesses, a more coherent timetabling of audits;
- improved data capture and processing, allowing taxpayers or their advisors to see a customer's history with the department and being able to offer appropriate advice and support;
- simplified payment methods and a single tax account, potentially allowing businesses to better manage their cash flows to and from Government; and
- education campaigns across the tax system, offered at relevant points on the business life cycle.

## Effectiveness

**3.43** Taken together, the revenue departments' compliance-related activities influence behaviour that affects a significant proportion of the tax gap. Improvements in these functions will stem from better sharing of information and an improved understanding of the impact of interventions on business customers across the tax system.

**3.44** Integration, in the context of the compliance functions, would not mean that all staff deal with all taxes or that every customer would only deal with a single revenue department official, no matter how complex their tax affairs. The revenue departments would need time to develop new ways of working that will improve effectiveness and customer service, although changes would be likely to include:

- improved business customer segmentation along the compliance continuum by moving towards a whole customer view (see Chapter 4), resulting in better targeting of interventions and education activity;
- a shift towards shared definitions and working practices, making it easier for taxpayers to comply;
- better use of specialist skills and best practice across the tax system;
- application of the indirect tax approach (with further steps towards real-time assessment and collection, and a more strategic approach to the tax gap) and transactional information to direct taxes;
- improved deployment of audit resources to optimise return on compliance activities; and

- a wider range of possible interventions when constructing disruption strategies to reduce fraud.

**3.45** Most of the transactional functions offer gains to efficiency and customer service, rather than effectiveness, although in as far as they can be used to provide a better understanding of customers, they will also increase effectiveness. These activities also have a role to play in improving debt handling.

**3.46** Attributing a value to the improvements in effectiveness and efficiency is difficult and uncertain. A full business planning exercise within any new organisational structures would help to clarify these issues. It is clear even without this exercise that there could be significant benefits from changes in some areas of the departments' activities – those where there is a significant customer overlap, and where similar transactional functions are performed. It is also the case that much of the departments' activity could be ring-fenced.

**Improving effectiveness through integrating audit**

**3.47** It could be argued that the differing nature of direct and indirect taxes makes it unlikely that benefits would be realised through the integration of compliance activities. However, the increasingly real-time approach to direct taxation combined with international experience and the similarities outlined below suggest that there is a good chance of realising the kind of benefits seen in Canada and Australia.

**3.48** Integrated audit across the tax system increases the revenue collected. The types of adjustment made by auditors in Canada and Australia between income tax and GST (equivalent to VAT) were similar – see Table 3.2. Furthermore, types of non-compliant behaviour were common and an adjustment for income tax would usually require an adjustment to GST, and vice versa.

**Table 3.2: audit adjustments from small business compliance work in Canada**

Income tax	GST
Unreported revenues	Unreported revenues
Under-reported revenues	Under-reported revenues
Disallowed personal expenses claimed	Input tax credits taken on personal items
Business expenses not technically deductible	Input tax credits taken on unsupported business expenses or items that do not qualify

*Source: Canada Revenue Agency*

## Efficiency

**3.49** The review has conducted an efficiency analysis to explore how staff totals might vary if efficiency gains were realised through integrating or sharing particular functions. In doing so, the review has worked closely with Sir Peter Gershon in his more general examination of efficiency in Government (see Annex E). The review has taken account of the departments' existing plans, which should achieve significant savings over the medium term, through improved process design, and better use of technology and other resources.

**Transactional efficiencies** **3.50** There has been a steady increase in the number of taxpayers choosing to use the Internet to interact with the departments. This area has great potential to achieve efficiency savings, as recognised by the Gershon review. The departments' e-programmes are designed to capture these – for example, receiving taxpayer information electronically allows it to be checked for errors more easily and quickly than on paper, and reduces the number of errors when customers input data (e.g. in arithmetic). This could potentially reduce the large number of staff currently required for transactional activities, and in turn provides a ready data source for improving customer service, compliance activity, and policy analysis. There is, however, some uncertainty about the scale of these potential gains, as they depend on maintaining the rate of uptake in E-filing in the medium to long term (see Chapter 4).

**3.51** Scope also exists to achieve more traditional efficiencies. The revenue departments have successfully achieved efficiency savings in a number of areas in recent years – for example the Revenue's recent regional reorganisation. But there is further progress that could be made. For example, around 53% of total staff in the Revenue work in data processing areas (including receipts and payments staff). Of these, roughly 24,000 are based within their local office network: 350 offices grouped into 71 areas with seven regional commands. While there will be a continued need to provide some customer-facing services at a local level, there may well be economies of scale that could be achieved through greater concentration of back-office functions, and through examining the office networks of the revenue departments and other Government bodies. Efficiencies could also be achievable through more flexible deployment across these functions.

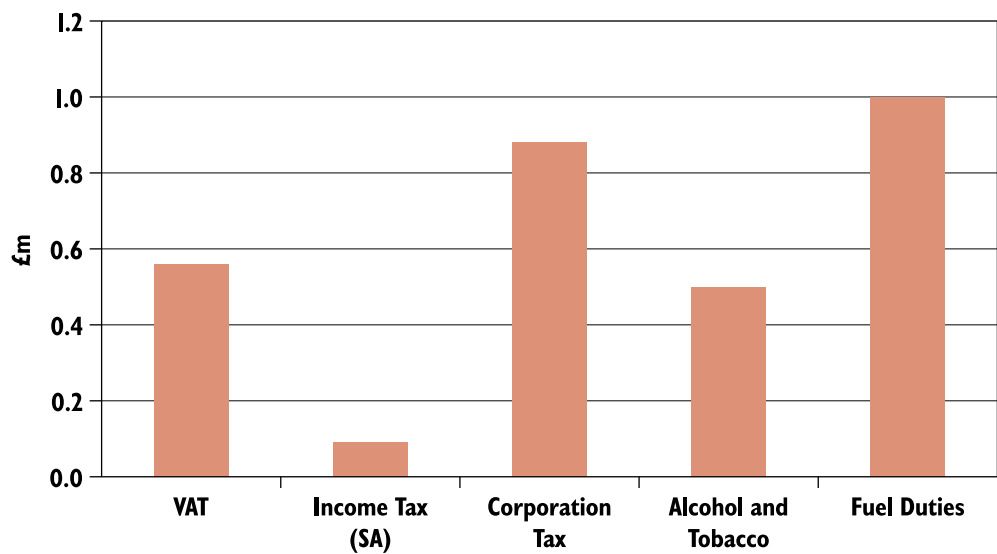
**3.52** Efficiency gains might also be achieved through a rationalisation of corporate support across the two departments. There might be potential economies of scale between the centre and the regional network that have not yet been realised – for example, more than 40% of all Revenue staff in the human resources, asset management and technology functions are based in the regions.

**3.53** While any improvement in efficiency is clearly worth securing (assuming that the longer term benefit outweighs the transition costs and risks), the largest efficiency savings are likely to be available in the transactional areas that support revenue collection but which are not tax specific. In other areas, work specific to individual taxes, tax credits, and Child Benefit would still be necessary, probably offering less scope for savings.

**Efficiencies and compliance** **3.54** Large numbers of staff work in the functions related to compliance, namely education, and audit, investigation and disruption. As Chart 3.2 indicates, the direct return on compliance activity for different taxes varies widely. This is not to suggest that compliance activity should cease in areas of relatively low return, because as noted in Chapter 2, there are indirect effects from deterrence of up to five times the direct impact of compliance work.<sup>17</sup> Compliance activity generally offers a substantial revenue return on resources invested, and this has to be factored into the efficiency analysis.

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<sup>17</sup> National Audit Office report *HM Customs and Excise: Improving VAT Assurance*, 24 November 1999, HC 15 Session 1999-2000, available at [www.nao.gov.uk](http://www.nao.gov.uk)

**Chart 3.2: estimated audit revenue (£m) per compliance staff year**

Source: Review team

## ASSESSMENT OF OPTIONS

### Separation, reallocation of taxes, or partial merger

**3.55** The options identified at the start of this Chapter are now assessed against the potential benefits outlined above. The less promising options are considered first, followed by three lead options.

#### Separate business and personal tax authorities

**3.56** The creation of entirely new tax organisations for businesses and for personal taxpayers has the superficial attraction of eliminating customer overlap and providing improvements in customer focus and consistency. The main problem with this approach is that direct taxes, in particular, do not divide neatly between businesses and individual taxpayers. The following examples illustrate this:

- both individuals and unincorporated businesses pay income tax; and
- PAYE, national insurance contributions, and tax credits are largely administered by businesses. However, unlike VAT, where the incidence is largely on business, the individuals concerned retain an interest in the payment of the tax (although similar compliance issues are raised).

**3.57** Separate business and personal tax authorities would therefore require considerable duplication for overlapping taxes (with the associated risk of inconsistency in these areas). The question of ownership and accountability in relation to technical and operational policy, for income tax and PAYE in particular, would be difficult to resolve. In addition there are:

- several functions where there are economies of scale for the revenue departments and taxpayers in consolidation across the taxes. For example, splitting transactional activities, such as receipts and payments, between two new organisations would involve significant transitional costs for little return;
- benefits in being able to allocate resources to take account of the relative returns to different activity across the tax system – these would be lost if separate authorities were established; and
- no international examples of separate personal and business tax authorities.

**3.58** The review, therefore, does not explore this option in more detail. However, the separation of large business from SME compliance activity works well in both Customs and the Revenue. As set out above, the IMF and OECD recommend a shift to a customer focus within a tax administration that is responsible for both direct and indirect taxes (as opposed to establishing separate customer-focussed organisations).

### Reallocation of taxes

**3.59** Although there is not a good case for the creation of separate business and personal tax organisations, it might be possible to improve customer focus through the reallocation of taxes between departments. Of particular interest are the possibilities of moving VAT to the Revenue or Corporation Tax to Customs, on the basis that this would put the main business taxes in one organisation.

**3.60** As noted above, the IMF favours the integration of direct and indirect tax administrations. As part of this, it supports the integration of VAT and direct business taxation, on the basis that integration can facilitate improvements in direct tax procedures and systems. A common approach to taxpayer classification could be introduced (e.g. simplified income tax systems for those below the VAT threshold). The IMF also suggests that integration can facilitate taxpayer education and thus help increase taxpayer compliance. The UK arrangement with Customs responsible for administering VAT is shared only with Israel and Malawi: most other countries have integrated direct and indirect tax administrations, and the few that do not have tended to integrate them in recent years (Denmark and Canada - Israel is also planning to integrate its administrations).<sup>18</sup>

**3.61** The reduction in the number of customers with significant interactions with two departments would be greater if VAT were transferred to the Revenue rather than Corporation Tax to Customs, because such a large proportion of personal taxes are collected by businesses. Separating Corporation Tax from PAYE, national insurance and tax credits would reduce the coherence of tax administration, rather than increase it.

**3.62** Bringing administration of VAT and Corporation Tax closer together would certainly support the Revenue's increasing use of real-time audit for large companies. However, in contrast to the creation of a single revenue department, there would be no capacity to allocate resources flexibly across the taxation system, and there would be

<sup>18</sup> Ebrill, L. et al, *The Modern VAT*, IMF 28<sup>th</sup> November 2001. Israel's recent plans: review team interview.

limitations on the scope for economies of scale between those functions common to all taxes.

**3.63** In addition, the transfer of VAT away from other indirect taxes makes little sense when viewed in terms of Customs' responsibility for and expertise in frontier control, investigation, and disruption. The nature of indirect taxes makes them more vulnerable to attack by fraudsters than direct taxes – in the case of VAT, because it can involve significant refunds to taxpayers. Customs has developed strategies for countering such attacks and has had some success in relation to frauds such as VAT MTIC (Missing Traders Intra-Community). These strategies depend heavily upon Customs' expertise in frontiers work, investigation, and disruption. MTIC fraud alone accounts for up to £2.6 billion of the VAT tax gap, and would be much more significant but for Customs' strategy to tackle it. If VAT were to transfer to the Revenue, there would be a risk that strategies to counter this sort of fraud would be disrupted, or Customs' expertise in these areas would have to be duplicated in the Revenue. This argues for maintaining responsibility in the same department for VAT, other indirect taxes, and frontiers work.

**3.64** It seems reasonable to conclude that there is little justification for unpicking a particular tax product from one department and stitching it into the other. The Treasury Select Committee took a similar view in its 2000 report.<sup>19</sup>

**Partial merger** **3.65** Any partial merger options could be achieved by either each department providing some services on behalf of the other with supporting service level agreements (after the necessary legislation had been passed), or creation of a separate service provider with which Customs and the Revenue could contract either stand-alone or as an agency of the Treasury.

**3.66** The integration of some revenue department functions would allow a partial organisation of tax administration by function, as opposed to organisation by customer or by tax type. However, the potential weakness of this organisational model is that service to taxpayers could deteriorate because each functional area would focus on a narrow aspect of taxpayers' affairs.

**3.67** There is a range of possible partial mergers. Simply merging support services appears to offer the least benefit. While the departments' terms and conditions remain separate, this would offer only small efficiency gains while still requiring a fairly substantial upheaval, with associated risks. In as far as support services need to be close to and understand front-line services to be effective, sharing only support services would bring fewer benefits to support services themselves than in the case of full integration, which would also bring about some alignment of the services that are being supported. This option would also provide nothing in terms of customer service or revenue collection improvements.

**3.68** Merging transactional functions as well as support services opens up the possibility of realising the efficiency and customer service improvements outlined above. However, as with the option of merging only support services, this option does not offer the benefits to compliance effectiveness of full integration, and would still entail considerable risk. The review assesses that there are clear benefits to integrating core compliance activities: any integration that did not include these would therefore be an opportunity lost.

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<sup>19</sup> Treasury Select Committee, *Second Report: HM Customs & Excise*, HC 53 Session 1999-2000, 8<sup>th</sup> February 2000, available at [www.publications.parliament.uk](http://www.publications.parliament.uk)

## Status quo plus, integration or strategic alignment

**3.69** *Status quo plus*, the creation of a new revenue department that integrates the Revenue and Customs, and strategic alignment are more promising because they appear to offer a better risk to reward trade-off than the options outlined above, which would involve considerable disruption, without achieving the benefits of full integration.

**Status quo plus 3.70** *Status quo plus* would involve preserving the existing organisational boundaries, while encompassing some internal reorganisation to implement the review's recommendations on policy and accountability, and in as far as this would be possible, information.

**Integrated department 3.71** The second lead option would be to create a new department that integrated Customs and the Revenue. This would start with the appointment of senior leadership and a joint board for the two departments. Since Commissioners of existing departments are established by statute, legislation would be necessary to create a new organisation. Pending such legislation, Commissioners could be 'double-hatted', exercising powers in different roles at different times.

**3.72** Although such a model would see some definite early steps, the change required to achieve the benefits sought (explored further below) would take a number of years to implement. An early task would be to develop career paths across the tax system. Reengineering is likely to include shared support and transactional services, rationalised customer interfaces and integrated compliance strategies and information systems. The development of a 'whole customer' view (see Chapter 4), improved risk assessment and the provision of a more holistic service for business customers would be priority objectives.

**Strategic alignment 3.73** The final lead option looks for a structure that would secure some of the benefits of creating a new department but at lower cost and risk. In principle an option where it would be possible to generate the benefits of creating a new department, but with less disruption, is attractive.

**3.74** Strategic alignment would involve keeping the two departments largely as they are, but establishing a new 'strategic board', comprising an independent chair, the chairs of the revenue departments, some other revenue department board members, and some non-executive members. The aim of the strategic board would be to drive work in high value added areas between the two departments.

**3.75** This strategic board could be given a remit by Ministers to achieve particular outcomes and be accountable for them (in line with the general accountability recommendations set out in Chapter 6). This might include:

- producing a single strategy setting out a high level outcome-based approach to closing tax gaps, reducing compliance costs and improving customer service for common business customers;
- developing a joint knowledge management capacity, enabling sharing of information, better risk modelling and better deployment of resources within existing departmental structures, including by ensuring convergence of IT; and
- building a common 'front end' to handle transactions with business.

**3.76** In effect, the strategic board (supported by a secretariat) would provide a new pressure on the departments to align their activity in support of overall objectives, something that has not been achieved in the ten years of closer working. It would be possible to add to the programme as new ideas emerged. Strategic alignment is also consistent with creating an integrated revenue department at some time in the future if that were thought desirable.

**3.77** Under strategic alignment, joint resources would be possible, although this could be difficult without aligning terms and conditions, and for legislation to be passed to permit one department to employ staff to pursue the statutory aims of the other.

**3.78** In general however the strategic alignment option would preserve more of existing organisations than creating a new department. Departmental chairs would continue to be responsible for their own department's expenditure, and to Ministers for implementing programmes, and the overall division of activity by tax or legal instrument would remain.

**3.79** These three options are now assessed to consider the extent to which they improve effectiveness and reduce compliance costs.

### Assessing effectiveness

**3.80** The review has identified a number of ways in which the effectiveness of tax administration could be improved. The new approaches described below would increase voluntary compliance, allowing greater targeting of the non-compliant, thereby improving deterrence, helping to close the tax gap. This would involve developing:

- a more strategic approach to the challenges in each area. Following a period of greater VAT and tobacco losses through the 1990s, Customs has developed a more focussed approach to its taxes, which shows early signs of success, and may take overall effectiveness back up to 1992 levels. Similar approaches should be taken in other areas, particularly on the Revenue side. The departments should develop an integrated approach to compliance, ensuring consistency between different areas of activity;
- more complete information and analysis to improve risk management. In the long term the departments should move towards a whole customer view through improved information systems, greater information sharing, and joint planning to allow for better risk based decisions, in particular, using real-time VAT information to inform direct tax work;
- integrated compliance work and audit of direct and indirect taxes. International experience suggests that this increases combined yield by improving performance on the direct tax side (see Box 3.3). It also offers scope for improved service to business by offering a consolidated approach; and
- better and more flexible use of resources. At present resources are allocated separately to Customs and the Revenue, and the respective boards decide how to best deploy them with the direct and indirect tax split pre-determined. This means that there is limited knowledge of marginal returns on investment across the tax system. Resource decisions are taken only in biannual spending rounds, meaning that rebalancing between those rounds is not possible.

**Box 3.3: the introduction of GST in Australia**

In 2000, Australia introduced Goods and Services Tax (GST, equivalent to VAT), which brought improvements in the effectiveness of existing taxes. The Australian example is in some ways comparable to that of the integration of tax administrations, as a broad-based indirect tax (GST) was added to the existing tax system. There are caveats to this:

- introducing a new tax provided the opportunity to introduce other changes (such as the Australian Business Number – see Chapter 4) and may also have encouraged businesses to keep more complete records and accounts, improving direct tax compliance;
- the UK is part of the EU's single market, and as such, detailed rules are agreed in the EU to govern VAT. This limits the extent to which VAT rules can be rapidly changed in the UK; and
- the GST has a lower threshold than VAT in the UK, meaning that it is paid by proportionately more taxpayers.

The Australian Taxation Office (ATO) judges that introducing GST has improved effectiveness by:<sup>20</sup>

- additional registration of businesses arising from the introduction of a common business numbers, and using common information across taxes, which makes avoidance harder, but also allows better risk assessment by the ATO;
- moving direct tax compliance work to real time, with abnormal financial transactions picked up and investigated immediately. For example the ATO is able to see large purchases of capital items and ensure they are accounted for correctly; and
- increasing overall coverage of audit work, increasing the deterrence effect, and allowing resources to be redeployed to increase yield.

The ATO estimated that GST would lead to the collection of an additional 1% of direct tax revenue each year.<sup>21</sup> Three years on, this target has been met.

In the past year, the ATO has moved to a fully merged compliance strategy for micro-businesses, which account for around 10% of overall tax revenue. In the first year, the ATO expects to collect an additional \$167m of direct taxes, a 21% increase in yield from compliance work over 2002-03, with further increases in the future as new staff improve their performance. These figures understate the true return, because the new programme has enabled the ATO to move existing direct tax experts to higher yield work. Furthermore, the shift to real time compliance work has helped to increase tax collected within the year from 60% to 80%, with a further improvement expected. This will mean an improvement in debt collection, both by collecting money while a business has it and by enabling a redirection of debt collecting resources. Taking these changes together equates to a more than 50% improvement from compliance activity upon this group.

<sup>20</sup> Source: review team interview.

<sup>21</sup> Australian Taxation Office. A\$1.1 billion out of a total of A\$117 billion in 1999-2000, from The cash economy under the new tax system, September 2003, available at [www.ato.gov.au](http://www.ato.gov.au)

Micro businesses have seen significant reductions in their compliance costs as a result of merging compliance work. The ATO’s approach is that if they expect small businesses to understand their obligations for administering income tax, corporate tax and GST, it is reasonable for auditors to master them as well, drawing on specialist advice as necessary.

**3.81** The review has assessed the potential for the three models to reduce the tax gap by examining the scope to pursue these approaches under each option. This is naturally an illustrative exercise.

**3.82** In the case of strategic alignment, the judgements are particularly difficult, as the model has split accountability. The strategic board, which would include the chairs of the revenue departments, would be responsible for strategy to Ministers. But the chairs would (separately) be responsible in their own right for their own department’s activities and spending. Under strategic alignment, differences in departmental culture could be expected to continue to be strong. As a result the strategic board could become a forum in which the revenue departments fight turf battles, rather than a body that drives the agenda. If that were the case, strategic alignment would be a more expensive version of *status quo plus*. It also might prove to be unstable, leading to renewed examination of integration after a few years of uncertainty. Giving the independent chair strong powers could reduce the risk of conflict, but this would begin to look like creation of a single department. Box 3.4 assumes that in practice strategic alignment achieves its promise.

**Box 3.4: scope for reducing the tax gap under three lead options**

Action	Status quo plus	New integrated department	Strategic alignment
Aligned strategies	Partly	Yes	Yes
Coherent approach to information and knowledge	No	Yes	Yes
Integrated compliance	No	Yes	No
Flexible resource allocation	No	Yes	No

*Source: Review team.*

**Assessing compliance costs** **3.83** As businesses are often customers of both departments, they potentially have most to gain in terms of reduced compliance costs from a more joined up approach. Concrete evidence on compliance costs is limited, but the evidence is that they are substantial and fall disproportionately on small and medium sized businesses, although are still significant for large businesses.

**3.84** The aim of change would be to minimise costs for a given revenue collection level. Under the current arrangements, each department separately considers the compliance costs it imposes on business, and changes are considered without taking into account the full picture. As a result, there is insufficient attention paid to the

potential benefits of aligning the details of regimes run by the two departments, and no built-in incentive to consider changes that increase costs in one area, but reduce them overall.

**3.85** Steps that would lead to lower compliance costs and better customer service would include a joint structure tasked with:

- developing a shared understanding of customers (the whole customer view);
- taking an overview of the services being provided, ensuring they were rational when viewed in the round and making improvements where necessary following consultation, for example in the way in which a taxpayer can get information and guidance on their liabilities, and taking an overview of how information and payments to the departments are handled; and
- as a side effect of the above, providing a powerful voice for service innovation and improvement in the policy debate.

**Institutional incentives** **3.86** A linked point is that the institutional incentives on those planning services are driven by individual departmental objectives and programmes, rather than in ensuring coherence with other departments. But both Government and customers are interested in coherent services across the board.

**3.87** In theory the Treasury can help to address this disconnect. In the current arrangements, officials and Ministers can encourage greater joining up, although the closer working experience suggests this is not a satisfactory mechanism. If the policy recommendations in this report are accepted there would be improved mechanisms for coherence across taxes. But this is unlikely to be a complete solution, since the Treasury could not replicate the in-depth implementation knowledge of the revenue departments.

**Box 3.5: the Canadian experience: part II<sup>22</sup>**

As noted in Box 3.1, in 1992 Canada started the process of integrating the counterpart organisations of the Revenue and Customs, with the process completed in 1997. In December 2003, the customs responsibilities of the integrated tax administration were transferred to a new border organisation. The tax administration was named the Canada Revenue Agency (CRA).

In designing the new organisation, the Canadians adopted what they described as a 'hybrid functional program' model, integrating all support functions, creating a single regional network but maintaining a separation between traditional Customs frontier and trade work on the one hand, and tax administration on the other (until customs was transferred to the border agency in 2003). The integration was not fully costed in advance although it was estimated that C\$200 million extra revenues could be achieved from compliance and C\$62 million saved on administrative costs per year. Corporate services were integrated first (finance, human resources, administration, IT, communications, corporate affairs and legal services), saving around C\$30 million per year. At an operational level the number of tax services districts were reduced from 75 to 40, and the frontier and trade administrations were reconfigured into one management structure each per region.

The CRA achieved some immediate successes in improving services, such as increasing accessibility through a wider network of offices and service points. However, more important were the longer-term initiatives which aimed to promote a more fundamental integration, many of which have UK parallels:

- a Business Number is now used for all transactions with CRA, replacing the multiple identifiers that businesses needed to deal with the separate departments (see Chapter 4);
- integrated accounting brings together all the separate tax and duty accounting processes into one system. Individuals and businesses can make payments, offset debits and credits between accounts and make other transactions in one place through one process; and
- integrated audit provides for one auditor or an audit team to conduct an audit of a taxpayer on all taxes and duties at one time, replacing the multiple visits that auditors would previously make.

The two aims of an integrated audit were to improve audit coverage, and reduce the levels of intrusion for taxpayers. In practice, implementation was difficult (see Annex A), but now the approach is well embedded the CRA have seen significant productivity gains and believe the main gain has been the reduction in compliance costs for small business.<sup>23</sup> The Canadian Taxpayers' Federation, the watchdog for small businesses and independent taxpayers, has been pleased with the simplification of customer interactions and their initial concerns about taxpayer privacy in relation to data mining and offsets have now abated. The Large Business Advisory Committee has also given positive feedback on the changes. Overall, the Canadian government and international organisations consider the integration to have been a success.

**Assessing efficiencies** **3.88** Staff savings through integration combined with transformational change in other parts of the public sector have permitted efficiency savings of the order of a few percentage points per year for a limited period. As noted above, the formation of DWP released savings of roughly 5% per year for a short period.

<sup>22</sup> Baker, W. *Organisational aspects and human resources problems in an integrated organisation*, lecture for the CIAT technical conference, Madrid 1997.

<sup>23</sup> Source: review team interviews.

**3.89** The review has worked closely with the ongoing Gershon efficiency review, which is informing the 2004 Spending Review. As set out in Annex E, Sir Peter Gershon assesses that very substantial resources could be released by making greater use of E-services and processes, and E-filing. The reforms discussed as part of the Gershon review dovetail with the proposed organisational and information reforms of this review. Overall, this review assesses that on the basis of existing plans, reforms proposed by the Gershon review, and additional changes from integration, there could be scope for overall efficiency savings equivalent to up to 14,000 jobs across the two departments by the end of 2007-8, the last year of the 2004 Spending Review period. This process of efficiency savings would need to be carefully managed by working closely with staff to ensure that the departments' effectiveness and service to customers is not undermined.

**Conclusion on benefits** **3.90** There are potentially significant benefits in adopting a new approach, in terms of the effectiveness of tax raising, improvements in customer service, and reductions in compliance costs, as well as efficiency gains. Several of the benefits relate to putting in place a structure allowing decisions to be made across the tax system. Those working in such a structure need:

- the information and incentives both to make decisions based on an overview of priorities, and to internalise trade-offs;
- the levers to ensure decisions are reflected in practice; and
- clear responsibility and accountability (see Chapter 6).

**3.91** Overall there are clear benefits in an administration that can look across the tax system, notably to:

- create the institutional incentives to drive better resource allocation;
- improve tax collection from the non-compliant and reduce the burden on the compliant, through better use of information and shared risk assessment;
- have one rather than two centres on compliance cost and customer understanding, to improve the likelihood of coherent decisions on service planning (including visits, information and education, on-line filing, consolidated tax accounts) and trade-offs between raising money and imposing costs, and to provide a strong voice to press customers' case; and
- provide further impetus in selected areas to process specialisation to increase productivity and achieve economies of scale, as well as create the flexibility to follow them through.

**3.92** There is a general challenge of finding the most appropriate decision making unit, which is a matter of balancing the need to have the widest possible perspective with the need for a manageable size and focus for the unit. In this case however, the extent of similarity between the operations of the revenue departments identified in the review, and the similarity of revenue objectives, suggests that the balance is not properly struck in current arrangements.

**3.93** While difficult to quantify, the benefits of integration appear large. *Status quo* plus would not achieve these benefits. Strategic alignment might achieve some of the benefits, but would not transform performance in the way that would be possible with the creation of a new department.

## TRANSITION RISKS AND COSTS

**3.94** To make an overall assessment of the best way forward, it is as important to consider the costs and risks of the different options as to consider the potential benefits. As part of this assessment, the review has benefited from input from leading external individuals with relevant experience (see Annex D).

**3.95** The review as a whole has drawn on this input, and particularly in the assessment of transition risks and costs. One important point that has been consistently made is that successful integrations concentrate on priority areas, and do not disrupt activity in other areas. It follows from this that, in the event of the creation of a new department, most staff should not see a dramatic change. Only those areas where there are significant potential benefits from integrating the activity of the two departments would be directly affected. And even for these areas, change should be phased where possible.

### Costs

**3.96** All options, including not changing, involve costs and risks. *Status quo* plus could involve opportunity costs. Under either strategic alignment or the creation of a new department, there would be joint development of projects, for example of the IT supporting a joint knowledge centre, where costs of developing a single system for both departments could be lower than the costs of developing separate systems.

**3.97** There would however be direct costs with both the creation of a new department and strategic alignment, which in practice might in the short term outweigh any efficiency savings (which is not to say that increases in revenue or reductions in costs to customers would be outweighed). For example, it would be necessary to provide elements of a common information platform for the new department, such as a common intranet, which would help to promote a common identity in the department.

**3.98** The creation of a new department could have potentially significant costs – in addition to costs of change already planned in the departments. These would depend on the precise nature of the package structured to meet the new business needs, and it might be possible to phase this in over time. Any move to create a new organisation would also require expenditure on rebranding.

**3.99** By way of comparison, when Jobcentre Plus was created, the benefit of providing a unified contact point for those claiming benefits and looking for work, in terms of efficiencies, job outcomes, and reductions in fraud and error, were projected to equal the investment cost within seven to eight years.

**Box 3.6: administrative costs under three lead options**

	<i>Status quo plus</i>	<b>New integrated department</b>	<b>Strategic Alignment</b>
<b>Human resources costs</b>	None	Potentially significant	Depends on extent to which staff are shifted between departments
<b>Rebranding, reorganisation new management structures</b>	Potentially some, but small	Potentially significant, depending on extent and speed of change	Small (servicing of strategic board, communication)
<b>New knowledge centre</b>	Significant	Significant, but less expensive	Significant, but less expensive
<i>Source: Review team</i>			

## Risks

**3.100** Overall, the direct financial costs of change, while quite significant, are likely to be smaller over time than the potential benefits of creating a new department or strategic alignment. Risk, however, is potentially much more important. The revenue departments are currently engaging in significant development, which in itself entails risks. The risk of further change falls mainly into two categories:

- disruption to ‘business as usual’, including revenue collection; and
- disruption to projects already in the pipeline.

**3.101** Any area of business could potentially be affected, although the area of greatest change, and therefore risk, would be where there is significant overlap or synergy between the departments.

### Risks to revenue collection...

**3.102** Change may cause problems for revenue collection in the short term. They may occur as a result of:

- disrupted priorities and working relationships leading to disorientation and demotivation;
- resources being focussed on change rather than delivery;
- customer confusion as a result of new systems; and
- poor change management (e.g. inadequate funding, poor issue identification, industrial action, IT failures).

**3.103** Assessing overall levels of risk is difficult, but the risk on the Revenue side appears to be lower than that on the Customs side, reflecting the nature of the taxes in question, and the way in which they are collected (e.g. with PAYE requiring relatively little intervention). Organisational change in the revenue departments might cause a reduction in revenues in two ways:

- despite the fact that an improvement in compliance effectiveness would be one of the main objectives of reorganisation, the effectiveness of compliance activity might be impaired in the short term; and
- a reduction in deterrence, or a failure in administrative systems that underpin the collection of tax that does not require intervention. Some normally compliant taxpayers might assume that a reduction in compliance effectiveness allows them to pay no or less tax, or a breakdown in systems might make payment less convenient, again reducing tax take.

**...in compliance related work...**

**3.104** The starting point in considering the first of these risks is that each department secures about £4 billion in additional revenue through direct intervention (about 2.5% of overall revenue).<sup>24</sup> Within the Revenue, a significant part of this rests on the performance of the Large Business Office (LBO) and the Special Compliance Office. While the LBO might be an early candidate for a new approach in a new department, any reorganisation would seek to maintain its existing capacity to encourage compliance.

**3.105** In 2001-02 compliance work by Customs yielded an additional £2.5 billion in VAT, around 4% of the total VAT take. The extensive organisational reforms introduced in recent years have had some impact on the trend in VAT receipts and the VAT gap, although evidence is limited. Customs estimate that they raise an additional £1.5 billion in tobacco, alcohol and oils revenue as a result of anti-smuggling activity. As smugglers might well respond quickly to a drop in the effectiveness of anti-smuggling efforts, maintaining the present levels of effectiveness in this area of operations is likely to be a priority for the incoming management of a new, integrated department. In any case, this area is unlikely to be directly affected by any restructuring of the revenue departments (as there is no counterpart in the Revenue to Customs activity in this area).

**...in other areas of revenue...**

**3.106** The second category is large – constituting the remaining £317 billion (in 2002-3, 97.5% of revenue) – but only a very small proportion of this total is likely to be affected. There are two considerations here:

- uncertainty created by reorganisation would also affect the potentially non-compliant taxpayers; and
- for some (large) revenue streams such as PAYE it would be reasonable to expect that compliance would continue to be high.

**3.107** The risk posed by a decline in deterrence or by administrative weaknesses would thus appear relatively low, particularly if the period of change were not drawn out. Vigilance would, obviously, need to be maintained, particularly in those areas most affected by change.

<sup>24</sup> Source: the Revenue and Customs Annual Reports, the sum of 'total estimated additional tax liability' (the Revenue) and 'revenue at risk' (Customs).

**3.108** As noted above, Canada and Denmark have recently integrated their indirect and direct tax departments. For technical reasons the Canadians were unable to measure the effect of integration on revenue, but senior officials in the CRA do not consider that any reduction in revenue was experienced in the short term, and believe that the integration has generally had a positive effect on revenue. In Denmark, overall tax revenue increased immediately after the integration, despite being accompanied by an 18% reduction in staff in one year.<sup>25</sup>

**3.109** Given this international experience, and the fact that while some revenue streams might suffer a decline, others might increase as a result of integration, the review assess that the risks to revenue can be mitigated through good planning and management.

### ...and other projects

**3.110** Other key projects in the process of being implemented or in the pipeline include:

- the next stage of work on existing priority projects such as the renewal of New Tax Credits starting in April 2004;
- work to achieve simplifications and improved services to taxpayers currently in hand in one or other department, such as the Revenue's Construction Industry Scheme and Modernising PAYE Processes for Customers;
- work on new policy commitments such as the Child Trust Fund and the Lorry Road User Charge; and
- non-revenue priorities such as the work being carried out in Customs to secure UK frontiers against smuggled radiological material.

**3.111** Introducing any organisational change would require projects to be evaluated to test their fit with the strategic direction. However, all of the above examples could be viewed as stand-alone, and would not necessarily be directly affected by organisational change.

**3.112** However, some projects will need to be redesigned to take account of new circumstances. The departments' e-programmes are a case in point. Against this, the departmental IT contracts have recently been relet, and both contracts provide some flexibility (see Chapter 4).

**Culture 3.113** It is apparent that the revenue departments, as a result of their different tasks and histories, have distinct cultures – while also having similarities in terms of the importance of integrity and commitment to public service. One study of the implementation of public sector mergers<sup>26</sup> stressed the importance of understanding cultural issues, and similar lessons emerge from both the Canadian and DWP case studies. This will be a priority issue for the departments' management to address in any change. Failure to do so would have implications for all of the risks outlined above.

<sup>25</sup> Source: review team interviews.

<sup>26</sup> Frumkin, P, *Making Public Sector Mergers Work: Lessons Learned*, Report for the IBM Centre for the Business of Government, August 2003.

## A NEW SINGLE REVENUE DEPARTMENT

**A strong case for change...** **3.114** The review has identified a strong case for change. *Status quo* plus is an option with low risk in the short term, but which cannot respond to the difficulties caused by rigidities imposed by the existing departmental structure. The review has shown that these are seriously affecting the ability of the two departments to perform to their maximum potential in supporting the economic and social well being of the country. This is not a reflection on the staff, who have performed to a high standard, but a result of sub-optimal organisational structures.

**3.115** Strategic alignment, if successful, could provide the UK with some of the benefits of creating a new department with less risk. It would not, however, allow fast progress towards addressing the fundamental challenges of coherent services and crosscutting tax administration. Furthermore, many would be suspicious of an underlying ‘hidden agenda’ that this arrangement was simply a precursor to a full integration, and the resultant uncertainty and suspicion could be counter-productive. There are also doubts over the clarity of accountability in a regime in which responsibility for strategy rests with one body – the strategic board – and responsibility for implementation (including accounting officer responsibilities) rest with another. The potential for continued departmental conflict over how to optimise them would remain.

**3.116** Creating a new department is the most radical option, opening the way to transformational change in the way the revenue departments conduct their business. It would be a major challenge to continue effective implementation, while developing plans consistent with the vision set out in this review. It carries substantial transitional risks and costs, but also potentially the greatest rewards in terms of effective tax collection, customer service and greater efficiency, and the review assesses that the benefits significantly outweigh the risks and costs. Because of the scale of the task, it is clear that creating the new department and managing existing work will be a considerable leadership challenge. As such, the new organisation should be headed by a full time Executive Chairman.

**...and stronger now** **3.117** While the Government has not in the past ruled out the integration of the revenue departments, it has in the past judged that other priorities, such as the introduction of tax credits, should take precedence. The review has also benefited from examining the success of the creation of DWP in 2001 as a customer focussed delivery organisation, and of examining the benefits of organisational change to revenue departments in other countries. The review assesses that now is the time to embark on the challenge of integrating the revenue departments, to create a new and more efficient tax service for the benefit of its customers and the exchequer.

**Recommendation: a new single revenue department should be established, integrating Customs and the Revenue.**

**Recommendation: the details of the implementation of this recommendation would be a matter for the management of the new department, but subject to this, the management should:**

- create a new culture and identity for the department, building on the cultures of Customs and the Revenue;

- expand career opportunities for staff, developing strong career paths to provide experience across the new department, with frequent interchange between the new department and the Treasury;
- structure the new department as far as possible around customers and functions rather than taxes, so that customer needs can be better met and compliance improved, for example by establishing an integrated large business office, and more specialised service to small businesses;
- develop a better focussed PSA target on customer service and compliance costs for the 2004 Spending Review, supported by work to develop understanding of compliance costs;
- develop a better focussed PSA target on compliance across the tax system for the 2004 Spending Review, supported by work to develop understanding of the tax gap and other compliance measures;
- generate significant cost savings through improved efficiency, in line with the proposals of this review and that of Sir Peter Gershon; and
- look to identify economies of scale and scope by developing new national services, and reviewing the local office network, including with other departments.

**3.118** This Chapter has presented the case for organisational change in the revenue departments. Chapter 4 examines a priority area for the proposed new department: the better use of information, both within the new department, and outside it, for the benefit of customers and the exchequer.