



House of Commons
Committee of Public Accounts

Inland Revenue Standard Report: New Tax Credits

**Thirty-seventh Report of
Session 2005–06**

*Report, together with formal minutes,
oral and written evidence*

*Ordered by The House of Commons
to be printed 27 March 2006*

HC 782
Published on 25 April 2006
by authority of the House of Commons
London: The Stationery Office Limited
£11.00

The Committee of Public Accounts

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Summary

In 2004–05 HM Revenue and Customs (the Department) paid £15.8 billion of Tax Credits.¹ The Department recalculates each award annually and has identified that for 2003–04 it overpaid some £2.2 billion to some 1.9 million families.² The Department estimates that there will be a similar level of overpayments for 2004–05 awards. This is primarily due to the nature of the scheme; awards are provisional and based on incomes of the previous year. Final awards are based on actual incomes and because incomes tend to increase many applicants have been overpaid. This level of overpayments is far higher than the Government envisaged when the schemes were designed.

The recovery of these overpayments has caused hardship to many families and the Department has struggled to manage disputes with applicants about recovery. It has made a provision for some £1 billion of doubtful debts.³

The Chancellor's Pre-Budget Report included new measures to simplify the Tax Credit scheme and reduce repayments of overpayments. The main change, as from 2006–07, will be to raise from £2,500 to £25,000 the threshold for increases in income which will be disregarded when provisional awards are re-assessed. There will also be new responsibilities on claimants to tell HMRC promptly about changes in their circumstances. The Department considers that these measures should eventually reduce overpayments by one third⁴ and limit automatically the rate of recovery of overpayments. Awards for the first three years of Tax Credits, will however, continue to be subject to the original provisions.

The Comptroller and Auditor General qualified his opinion on the Inland Revenue's Trust Statement as Tax Credit overpayments arising from claimant error and fraud were initially estimated at around 3.4% by value, some £460 million.⁵ This is an early estimate and the figure is expected to rise once the Department's investigations have been completed. The Department closed the Tax Credits internet facility on 2 December 2005 because of attempts to defraud that system.

There were serious problems with the computer systems during the introduction of Tax Credits in April 2003, which continued to have ramifications in 2004–05. The Department considered that the IT contractor (EDS) was responsible for these problems and sought compensation. On 22 November 2005 the Department announced that it had concluded a settlement of £71.25 million with EDS. Of this sum, £26.5 million will depend on EDS winning future work from the Government. The agreement includes a confidentiality provision.

The Committee attaches great importance to difficulties experienced in the implementation of Tax Credits and will wish to return to this subject in the future to establish the extent to which these difficulties have been addressed.

1 C&AG's Standard Report on the Accounts of the Inland Revenue 2002–03 (HC 446, Session 2005–06) para 2.6

2 *ibid*, para 2.11

3 *ibid*, para 2.49

4 Q 26

5 C&AG's Report, para 2.3

Conclusions and recommendations

- 1. HM Revenue and Customs (the Department) overpaid £2.2 billion of Tax Credits in 2003–04 to some 1.9 million families, representing one third of those claiming Tax Credits.** The recovery of these overpayments has caused hardship to some families, and the Department has struggled to manage disputes about recovery. The Department is unlikely to recover the full amount of overpayments and by March 2005 had provided for almost £1 billion of doubtful debts. The Department's annual report should provide an explanation and quantification of these overpayments and the recovery action it is taking.
- 2. There have been unforeseen overpayments due to software errors and the Tax Credits computer system is fragile.** The Department has estimated that software errors led to overpayments of £184 million in 2003–04 and 2004–05. Software problems continue to result in errors. The Department needs to analyse and rectify these software errors to achieve a robust and stable computer system.
- 3. The Government announced important changes to the Tax Credit scheme in the December 2005 Pre-Budget Report, including raising the disregard for increases in income from £2,500 to £25,000.** The Department considers that the overall cost of the package is broadly neutral but, because of the absence of good quality data, it does not know the specific cost of the individual changes that have been announced. The existing £2,500 disregard is estimated to cost £800 million, so the cost of the package is likely to be significant. Before the Pre-Budget Report the Department estimated the cost of this element of the package. The Department should provide details of the estimate it has made.
- 4. Some overpayments are inherent in the design of Tax Credits, as initial awards are based on claimant circumstances and income for previous years.** Changes announced in the Pre-Budget Report should reduce these overpayments, which account for one third of the total. The Department does not have comprehensive information on how other overpayments are caused. It should undertake further work to analyse the cause of overpayments to determine if they can be reduced further.
- 5. The experience of Tax Credits illustrates the difficulties where information from claimants, necessary for the efficient administration of the scheme, is not available or takes time to obtain.** In implementing the Tax Credits scheme, the Department should have taken more care in its design and testing of the administrative arrangements and the requirements placed on claimants.
- 6. Changes announced in the Pre-Budget Report place new responsibilities on claimants to tell HMRC promptly about changes in their circumstances.** The Department has not provided adequate advice to applicants in the past and it acknowledges that improved communications are vital in helping claimants understand the recent changes. It should consult on its plans for communicating these changes with bodies in the voluntary sector that advise claimants. It is also incumbent on the Department, having demanded prompt information from

claimants, to be ready to process it accurately and quickly enough to prevent any accumulation of overpayments or underpayments.

7. **The Department does not have reliable or up to date information on levels of claimant error and fraud in Tax Credits.** The absence of this information and its analysis seriously impairs the Department's management of the schemes and its ability to safeguard taxpayer's money. As we stated in our last report on Tax Credits,⁶ the Department should quantify and analyse in detail its final estimate of overpayments due to error and fraud and should publish the results along with its targets for reducing these types of overpayments and its plans for achieving its targets.
8. **The design of the Tax Credits scheme limits the Department's ability to estimate the overall level of error and fraud.** Final estimates of error and fraud for 2003–04 will not be available until Spring 2006. In designing similar schemes in the future, Departments should assess the risk of error and fraud and their ability to identify and manage it.
9. **There has been a serious assault on the Tax Credits system by organised criminals and the Department closed the Tax Credits internet site on 2 December 2005.** Given the severity of the attack, in which identities were stolen to submit fraudulent claims, the Department needs to assess the adequacy of its fraud risk assessment and the effectiveness of its controls before deciding on whether to re-open the internet facility. It also needs to consider the wider implications of the fraud, including whether its defences for telephone access are strong enough.
10. **The Department agreed a sum of £71.25 million in settlement of its claim against EDS for the Tax Credits computer problems.** Of this sum, £26.5 million will depend on EDS winning future work from government, but there is no guarantee that it will win sufficient business to trigger full payment. Government should not be placed in the invidious position of having to commission further work from a contractor in order to recover compensation for underperformance.
11. **The terms of the settlement are covered by a confidentiality clause and have not been disclosed by HMRC or EDS.** Confidentiality arrangements should not be accepted where they will impair accountability for public money. Contractors need to accept that, if they do business in the public sector, the terms of such settlements should be in the public domain. The Treasury should require Departments to abstain from confidentiality clauses in settlements with contractors, as is the case of severance compensation packages.

6 5th Report from the Committee of Public Accounts, *Inland Revenue: Tax Credits and deleted tax cases* (HC 412, Session 2005–06) conclusion 4, page 4

1 Overpayments of Tax Credits

1. HM Revenue and Customs (the Department) has paid some £45 billion in Child Tax Credit and Working Tax Credit Schemes (new Tax Credits) since they were introduced in April 2003. The Department paid £15.8 billion of this in 2004–05 to 5 million families.⁷

2. Overpayments were an inherent feature of the scheme.⁸ A Tax Credit award is provisionally based on a family's income and circumstances from preceding tax years. The final award will be lower than the provisional award if income has increased, but up to now, the Department has sought to recover overpayments only where incomes increased by over £2,500. From April 2006 the scheme should be easier to administer as a result of changes in the disregard but it is impossible to draw a firm conclusion yet.

3. The Department overpaid some £2.2 billion in 2003–04 to some 1.9 million families, about one third of families claiming Tax Credits. The Department does not yet know the level of overpayments for 2004–05 awards, but estimates that it is likely to be similar to those for 2003–04.⁹

4. When the schemes were designed, the Government expected one million overpayments in the first year falling to 750,000 in subsequent years.¹⁰ In practice, the scale of overpayments has been much higher. The Department explained that this was because income rises in excess of the £2,500 threshold have been greater than anticipated and that many families underestimate their expected income when notifying the Department of a change in circumstances.¹¹ But the Department has limited information to allow a full analysis of the cause of overpayments.¹²

5. Recovery of overpayments does not automatically take individual circumstances into account¹³ and has caused considerable distress to some families. Many of these are amongst the most vulnerable in society and face severe difficulties in trying to repay the money. Claimants can make repayments over several years to alleviate hardship, and the Department expects to take until at least 2009–10 to recover overpayments from 2003–04.¹⁴ It recognises that it will not recover all of them and has provided for some £1 billion of doubtful debts at March 2005.¹⁵

6. In 2004–05 the Department faced severe difficulties in managing some 217,000 disputes against the recovery of overpayments. The Department employed some 8,200 staff in managing the scheme and redeployed staff resources from other work to deal with Tax

7 C&AG's Report, para 2.6

8 Q 57

9 C&AG's Report, para 2.13

10 Q 25

11 Q 25

12 Ev 14–15

13 Q 156

14 C&AG's Report, para 2.11

15 *ibid*, para 2.49

Credit problems. The Department has concerns about whether this created risks in other areas and explained that with the benefit of hindsight, it would have been more conservative in using Pay As You Earn income tax staff.¹⁶ Errors in the administration of Pay As You Earn were highlighted in the C&AG's Report which noted that each year at least £575 million of tax due is not being pursued and that taxpayers are not being advised of some £295 million due to them.

7. The design of the new Tax Credits necessarily resulted in overpayments, but there have also been unforeseen overpayments. A number of software errors, for example the omission of one partner's income in the processing of joint claims¹⁷ resulted in overpayments of £184 million in 2003–04 and 2004–05. The Department is continuing to investigate the reasons for other incorrect payments caused by system miscalculations.¹⁸

8. As the Tax Credits computer system is very complicated and fragile, the Department has been cautious in making changes.¹⁹ The Department did not feel it knew enough about the computer system and considered that it was still a cause of concern.²⁰

Changes to the Tax Credit scheme announced in the Pre-Budget Report

9. The Pre-Budget Report on 5 December included important changes to the Tax Credits scheme, which are intended to reduce the level of overpayments. The main change is that from April 2006 the Department will disregard increases in income between one tax year and the next of up to £25,000 when finalising awards. The full effect of the measures will not be seen for some time, and the Department will have to manage the challenges of the existing system for 2005–06 awards which will still be subject to the existing £2,500 income disregard.

10. The Department could not say how much it would cost to increase the income disregard threshold from £2,500 to £25,000. It noted that the difficulty in accessing good quality data makes costing the individual elements of the package difficult.²¹ The cost is likely to be significant, because the Department calculated that the final entitlement to Tax Credits for 2003–04 would have been £800 million lower without the existing £2,500 disregard.²²

11. Other changes announced in the Pre-Budget Report are designed to help keep claimant records up to date and reduce the build up of overpayments. The Department will require applicants to notify it much more promptly about changes in circumstances. It will also be more pro-active in contacting certain applicants to ensure their records are kept accurate. The Department stressed that it faced a big challenge in communicating with applicants to

16 Q 78

17 C&AG's Report, para 2.25

18 *ibid*, para 2.24

19 Q 12

20 Q 11

21 Ev 14–15

22 C&AG's Report, para 2.10

ensure these changes were successful.²³ It expects these changes to reduce overpayments by one third.

12. The Government also announced that from November 2006 automatic limits would be placed on the recovery of overpayments when awards were adjusted within the year following a reported change in circumstance. These overpayments had been recovered at a faster rate than those identified after the year end.²⁴ The Department was, however, unable to estimate the full extent of the recovery of in-year overpayments.²⁵

23 Q 68

24 Q 73

25 *ibid*

2 Error and Fraud in Tax Credits

13. Tax Credits carry the risk of fraud through applicants providing false information, for example understated or undeclared income, or by mis-representing their circumstances. There is also a risk that applicants may make genuine errors in their applications which may result in incorrect awards. The C&AG qualified his audit opinion on the Inland Revenue Trust Statement accounts for 2003–04 and 2004–05 in respect of applicant error and fraud in Tax Credits.

14. Under the previous Tax Credits scheme the Department estimated that overpayments due to claimant error and fraud amounted to 10 to 14% by value. The Department informed this Committee in December 2003 that error rates would be halved with the introduction of the new Tax Credits. But in January 2005, it could not confirm if it had achieved this and expected to complete its work on error and fraud rates by mid 2005.

15. The Department is still working to quantify the likely levels of error and fraud for the new Tax Credit schemes. In July 2005 it explained that due to the time needed to complete these investigations, final results for 2003–04 would not be available until Spring 2006. By then some £45 billion will have been spent on Tax Credits, the information will be out of date and the Department will only be able to use the results to target reductions in errors in 2006–07 awards.

16. The Department has made an interim estimate that it overpaid £460 million (around 3.4% by value) because of applicant error and fraud in 2003–04. But the final figure will be higher²⁶ because the completed work involved the easiest cases and it is likely that the more complicated cases will contain more errors and attempts at fraud.²⁷

17. The Department has acknowledged that better checks could have been made where claimants notified them of changes of circumstances which affected their award.²⁸ Measures designed to improve compliance were announced in the Pre-Budget Report in December 2005.

Organised crime

18. The Department estimated that some £15 million has been lost because of organised fraud.²⁹ It closed the Tax Credit internet facility on 2 December following a concerted effort by organised criminals to defraud the system. This attack followed the theft of some 13,000 Department of Work And Pensions staff identities, which were then used to submit false claims. The extent of the attack shifted the Department's view of the balance to be struck between claimant accessibility to the system and the risk of fraud, which it now judges as severe.³⁰ The Department was at a very early stage of knowing the full extent of

26 Q 18

27 Q 21

28 C&AG's Report, para 2.45

29 Qq 89–90

30 Q 71

the fraud, but believed its fraud screening had stopped the majority of attempts. It had established a Tax Credits Organised Fraud Strategy Board to oversee its work on fraud.³¹

19. The risk of Tax Credit fraud is not limited to claims made over the internet. There are different and particular risks for each channel through which Tax Credits can be claimed and the Department acknowledged that there are potential risks to any application.³²

31 Q 83

32 Q 88

3 The Department's Settlement with EDS

20. Serious problems with the introduction of the computer systems used to support Tax Credits delayed the processing of claims and led to incorrect payments being made. The Department assessed the gross losses attributable to EDS for the computer problems at £209 million, of which £105 million is overpayments the Department is seeking to recover from claimants. The remaining £104 million comprises £39 million overpayments that have been written-off and a further £65 million in respect of additional administrative costs and costs of fixing the computer systems.

21. In 2003, the Department commenced negotiations with EDS (the Department's former IT supplier) for compensation. On 22 November 2005 it announced it had settled its claim for £71.25 million. The settlement includes cash payments by EDS and the off setting of certain amounts which would otherwise have been due from HMRC to EDS. Of this sum, however, staged payments of up to £26.5 million are contingent on EDS winning new business with the United Kingdom Government. EDS informed the Department that it expects to receive a large amount of new business from the Government as a result of its participation in various procurement competitions both for new agreements and under existing agreements. There is however no guarantee that EDS will win sufficient new business to trigger payment of the full amount.

22. The implications of the settlement for EDS's UK tax liabilities did not form part of the negotiation³³ and the Department's Tax Inspectors will make a judgement on the tax treatment in the normal way.³⁴ The maximum tax deduction EDS could obtain for the compensation is 30% of the settlement.³⁵

23. The Department's strategy in its negotiations was to maximise the cash received from EDS³⁶ and it received advice from its lawyers to accept the settlement.³⁷ The Department also explained that the amount needed to be seen in the context of a contractual liability cap of £31 million for each element of default.³⁸ As noted in our predecessor's Report of September 2005³⁹ the contract with the Department's new IT provider, Capgemini, includes a more severe penalty regime, although such clauses inevitably affect the price of the contract.

24. The Department commented that there was no public sector or other guidance for handling this type of negotiation.⁴⁰ The final settlement was accepted by the HMRC

33 Q 171

34 Q 185

35 Q 173

36 Q 170

37 Q 177

38 Q 159

39 5th Report from the Committee of Public Accounts, *Inland Revenue: Tax Credits and deleted tax cases* (HC 412, Session 2005–06), para 24

40 Q 231

Chairman and his Departmental Executive Committee. HM Treasury approved the settlement, but did not influence its shape.⁴¹

25. The terms of the agreement include a confidentiality requirement. Final settlement of the dispute is contingent on EDS paying the full amount of £71.25 million, and the Department has reserved the right to reopen court proceedings if the full amount is not received. The Department therefore considers that the nature of its case against EDS and its overall strategy needed to remain confidential because it would be at a disadvantage if it had to make public its litigation tactics or any part of its lawyers' assessment of the strengths and weaknesses of the case against EDS.⁴²

26. Further distress and hardship to families may result from the recovery of overpayments of tax credits arising from these computer problems. It is not clear if the Department will recover the full £105 million of overpayments and some may be written off. The Department's ability to recover this amount will be important in assessing the value for money of the settlement.

41 Qq 169–170

42 Q 127

Formal minutes

Monday 27 March 2006

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Mr Greg Clark
Mr Ian Davidson
Helen Goodman

Mr Sadiq Khan
Mr Austin Mitchell
Mr Alan Williams

A draft Report (Inland Revenue Standard Report: New Tax Credits), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 26 read and agreed to.

Summary read and agreed to.

Conclusions and recommendations read and agreed to.

Resolved, That the Report be the Thirty-seventh Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned until Wednesday 29 March at 3.30 pm.]

Witnesses

Wednesday 14 December 2005

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Mr David Varney, Mr Paul Gray CB, Mr Stephen Jones, Mr Dave Harnett CB,
HM Revenue and Customs, and **Mr Jonathan Athrow,** HM Treasury

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Second Report	The regeneration of the Millennium Dome and associated land	HC 409 (<i>Cm 6689</i>)
Third Report	Ministry of Defence: Major Projects Report 2004	HC 410 (<i>Cm 6712</i>)
Fourth Report	Fraud and error in benefit expenditure	HC 411 (<i>Cm 6728</i>)
Fifth Report	Inland Revenue: Tax Credits and deleted tax cases	HC 412 (<i>Cm 6689</i>)
Sixth Report	Department of Trade and Industry: Renewable energy	HC 413 (<i>Cm 6689</i>)
Seventh Report	The use of operating theatres in the Northern Ireland Health and Personal Social Services	HC 414 (<i>Cm 6699</i>)
Eighth Report	Navan Centre	HC 415 (<i>Cm 6699</i>)
Ninth Report	Foot and Mouth Disease: applying the lessons	HC 563 (<i>Cm 6728</i>)
Tenth Report	Jobskills	HC 564 (<i>Cm 6724</i>)
Eleventh Report	Local Management of Schools	HC 565 (<i>Cm 6724</i>)
Twelfth Report	Helping those in financial hardship: the running of the Social Fund	HC 601 (<i>Cm 6728</i>)
Thirteenth Report	The Office of the Deputy Prime Minister: Tackling homelessness	HC 653 (<i>Cm 6743</i>)
Fourteenth Report	Energywatch and Postwatch	HC 654 (<i>Cm 6743</i>)
Fifteenth Report	HM Customs and Excise Standard Report 2003–04	HC 695 (<i>Cm 6743</i>)
Sixteenth Report	Home Office: Reducing vehicle crime	HC 696 (<i>Cm 6743</i>)
Seventeenth Report	Achieving value for money in the delivery of public services	HC 742 (<i>Cm 6743</i>)
First Special Report	The BBC's investment in Freeview: The response of the BBC Governors to the Committee's Third Report of Session 2004–05	HC 750 (<i>N/A</i>)
Eighteenth Report	Department for Education and Skills: Improving school attendance in England	HC 789 (<i>Cm 6766</i>)
Nineteenth Report	Department of Health: Tackling cancer: improving the patient journey	HC 790 (<i>Cm 6766</i>)
Twentieth Report	The NHS Cancer Plan: a progress report	HC 791 (<i>Cm 6766</i>)
Twenty-first Report	Skills for Life: Improving adult literacy and numeracy	HC 792 (<i>Cm 6766</i>)
Twenty-second Report	Maintaining and improving Britain's railway stations	HC 535
Twenty-third Report	Filing of income tax self assessment returns	HC 681
Twenty-fourth Report	The BBC's White City 2 development	HC 652
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Twenty-sixth Report	Assessing and reporting military readiness	HC 667
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Twenty-ninth Report	Excess Votes 2004–05	HC 916 (<i>N/A</i>)

Thirtieth Report	Excess Votes (Northern Ireland) 2004–05	HC 917 (N/A)
Thirty-first Report	Northern Ireland's Waste Management Strategy	HC 741
Thirty-second Report	Working with the voluntary sector	HC 717
Thirty-third Report	The Royal Parks and the Diana, Princess of Wales Memorial Fountain	HC 644
Thirty-fourth Report	Returning failed asylum applicants	HC 620
Thirty-fifth Report	The refinancing of the Norfolk and Norwich PFI Hospital	HC 694
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Thirty-seventh Report	Inland Revenue Standard Report: New Tax Credits	HC 782

The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number

Oral evidence

Taken before the Committee of Public Accounts

on Wednesday 14 December 2005

Asterisks in the oral evidence denote that part or all of a document has not been reported, at the request of HM Revenue and Customs and with the agreement of the Committee.

Members present:

Mr Edward Leigh, in the Chair

Greg Clark
Helen Goodman
Mr Sadiq Khan

Mr Austin Mitchell
Stephen Williams
Mr Alan Williams

Sir John Bourn KCB, Comptroller and Auditor General, National Audit Office, gave evidence.

Ms Paula Diggle, Treasury Officer of Accounts, and **Mr Jonathan Athow**, Team Leader, Work Incentives & Poverty Analysis Team, HM Treasury, gave evidence.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

INLAND REVENUE STANDARD REPORT: NEW TAX CREDITS (HC 446)

Witnesses: **Mr David Varney**, Chairman, **Mr Paul Gray CB**, Deputy Chairman, **Mr Dave Hartnett CB**, Director General, and **Mr Stephen Jones**, Finance Director, HM Revenue & Customs, gave evidence.

Q1 Chairman: Good afternoon and welcome to the Committee of Public Accounts where today our hearing is on the Comptroller & Auditor General's Report on the Inland Revenue, particularly tax credits. We welcome David Varney who is Chairman of the Inland Revenue. Would you like to introduce your team?

Mr Varney: Thank you, Chairman. On my left is Paul Gray, Deputy Chairman of HM Revenue & Customs, also with a particular responsibility for tax credits. Next to him is Dave Hartnett who is a member of ExCom, the Director General responsible for large businesses and employers, anti-avoidance and central compliance; and Stephen Jones on my right who is Finance Director and responsible also for the integrated business streams and excise and stamp duties in HM Revenue & Customs.

Q2 Chairman: So Mr Varney, what is going to be the annual cost of increasing income disregard from £2,500 to £25,000.

Mr Varney: Paul, would you like to take that?

Mr Gray: This is one measure out of the package of measures which the Chancellor announced in the Pre-Budget Report. The overall cost of the package of all those measures over a number of years is broadly neutral with a small negative effect in the first year and small positive effects in the next two years.

Q3 Chairman: Could it be as much as the £2.2 billion tax credit overpayments in 2003–04? Is that figure right? Were there £2.2 billion worth of Tax Credit overpayments in 2003–04?

Mr Gray: On the latest figures, yes.

Q4 Chairman: If that figure was right, why is it not possible that the cost could be as much as that? Is it not true to say, rather than your emollient reply, that the costs could be anything from £1.5 billion and £2 billion to us the taxpayers?

Mr Gray: The underlying reasons why the overpayments were at that level—

Q5 Chairman: I am not interested in the underlying reasons, Mr Gray. I am interested in you answering the question that I put to you. Could it be as much as £2.2 billion worth of Tax Credit overpayments in 2003–04? Mr Varney?

Mr Varney: No, it would not be as much as that.

Q6 Chairman: What would it be then?

Mr Varney: The reason for the increase in overpayments reflects partly income increases during the course of the year but that is only one of a number of factors which explain the level of overpayments.

Q7 Chairman: Mr Varney, would it be fair to say you got it wrong in designing a system which built in overpayments which you are expecting to receive back from vulnerable people who cannot afford to pay the money back to you?

Mr Varney: The system was designed by Parliament and that is the system which we are implementing.

Q8 Chairman: So whether or not you designed it, it was wrong, was it, or not?

Mr Varney: No, what we have done is—and you can perhaps never win in these circumstances—is we have looked at the way the system has operated, we have come up with a plan which is to improve

 HM Revenue and Customs

communications and make it easier to deal with us and there have been some policy changes which were announced in the Pre-Budget Report.

Q9 Chairman: That is a complete non-answer to the question I have asked you but I will let colleagues develop that, I cannot go on all afternoon about it. We will have to try and do better than that and make at least an attempt to answer some of these questions. This higher income disregard will not be implemented until April 2006; is that right?

Mr Gray: That is right, yes.

Q10 Chairman: So will you still be trying to recover current overpayments and those yet to be identified for 2005–06?

Mr Gray: For 2005–06 the income disregard will stay at £2,500.

Q11 Chairman: A lot of it was caused by software problems. When will you resolve these software problems, do you think?

Mr Varney: I think that is rather difficult. What we have got is a system which has had three major releases which have gone smoothly. As I think I have said before, the system is stable but we do not feel we know enough about the system to be clear of its resilience, so it is still a source of concern but at the moment it is performing well given the approaches we have taken to the releases.

Q12 Chairman: Performing well despite all these problems it has caused with incorrect payments?

Mr Varney: The last three releases, as I say, went in and have performed well. What we have done is looked very carefully at what we have put in. We still do not feel we know enough about the system. It is a very complicated system. What we have got is a stable situation and we treat that as stable but fragile, so we approach each of the releases with a degree of caution.

Q13 Chairman: By the Spring of 2006 you will have spent some £45 billion on tax credits; is that right broadly?

Mr Gray: Broadly.

Q14 Chairman: So having spent all this amount of money you can presumably now give us an accurate figure for fraud and error, can you?

Mr Varney: No, we cannot. As I said a year ago when we had the discussion on Tax Credits, because of the time lags we will not finish the research that we are undertaking into error and fraud until the Spring of 2006 and we use that as a benchmark for reducing the amount of fraud and error going forward.

Q15 Chairman: How can you come to a Committee in Parliament having spent £45 billion of public money and still not be able to give us any intimation of what is your estimate of fraud and error? It is unbelievable.

Mr Varney: I did give you an intimation.

Q16 Chairman: Is it 3.4%?

Mr Varney: As I said, with the 3.4% what has happened is the easiest cases have been looked at first. They therefore are likely to give a misleading impression of what is error and fraud.

Q17 Chairman: Exactly so, because you looked at the easy cases first that is how this figure of 3% is being bandied around but the fact is it could be far higher than that, could it not?

Mr Varney: That is exactly what I wrote to you and said. That is what I said in the letter.

Q18 Chairman: Why can you not give us some intimation of what it might be? You must have some idea.

Mr Varney: I do not. I am exactly in the position I was where I said that we have got to go through the completion of the cycle. The nature of the new Tax Credits is that there is a delay because you are looking at what happens in the year behind you, and therefore what we have done is pulled out cases for detailed inspection, and that takes time. It is no surprise that the ones that we can address first are the ones which are the simplest and the cleanest. I have been very clear, I think, but let me be clear now if I have not been clear, that the figure that was quoted is at the low end of what will be error and fraud.

Q19 Chairman: So you do have some idea then?

Mr Varney: No, but I know it will not be less than the low number.

Q20 Chairman: How do you know that?

Mr Varney: Because the cases that were progressed were the easiest.

Q21 Chairman: Exactly.

Mr Varney: And it is likely in the complicated cases there will be errors and there may even be attempts at fraud.

Q22 Chairman: The Paymaster General in May 2005 announced improvements to identify IT system problems and processing errors more quickly; is that right?

Mr Varney: She announced them.

Q23 Chairman: When do you expect to do this?

Mr Gray: We have a continual series of IT improvements to the system. There are two major software releases each year. During the course of the current year we have had successful releases to improve some of the aspects of the IT systems, including last month a very successful set of releases to make some minor amendments. We have a programme of two large releases each year going forward over the next two years which will be putting in place a number of the system fixes but also the enhancements to the system which were part of the package announced by the Chancellor in the Pre-Budget Report.

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Q24 Chairman: Okay. PAYE, lastly, what is your estimate, Mr Varney, of the tax that will be lost before you have resolved the main PAYE system failures or problems?

Mr Varney: We have got two sets of problems, one of which we have quantified at least for one year, which is dealing with multiple sources of employment where we have got a PAYE system which is based on employment and not on the employee. We are looking to introduce functionality in 2007 (so it will take impact in 2008) which will help us to bring together those cases. As I said in my statement about the quality of control, we have also got an issue about benefits in kind which we think will be of the same sort of order, maybe slightly more than the impact of multiple employment, and that too we are looking at to see whether we can do something to automate the process. We have introduced some IT to do calculations of tax codes which will help and we have done a bit more training to see if that will help.

Chairman: Thank you very much, Mr Varney. Helen Goodman?

Q25 Helen Goodman: I would like to begin by asking you some more questions about this overpayment of Tax Credits. Roughly speaking, the overpayments due to the design of the system were about two-thirds to three-quarters of the total overpayments in 2003–04. Is that correct, with about 25% due to fraud and error?

Mr Varney: I do not think I can say fraud and error. Some of the overpayments were caused by computer system error when we started because the computer system did not work as well and then we have had more overpayments than we expected when the system was designed. What was said to Parliament was in the first year there were expected to be one million overpayments and a steady state basis of 750,000 overpayments. We think that some of the computer problems exacerbated the million, plus the fact we had to use in the first year income which was two years old to guess what the entitlement was. That has caused that. I do not think we would be in a position to say error and fraud is responsible.

Mr Gray: I think there are a number of reasons why the extent of overpayments was greater than had been estimated before the system was launched other than fraud and error. One is that the extent and variation of income rises was greater than anticipated on the basis of that £2,500 figure. A second factor is that there has been a significant trend of families overestimating the extent to which their income has fallen and is likely to have fallen for the year as a whole when they have notified us of a change of circumstances, so that has led to the end of year payment being higher than expected.

Q26 Helen Goodman: You can stop now because my question was really a preliminary to my next question which is what do you think the impact on overpayments will be of the Chancellor's announcement last week both in terms of reduced overpayments and in terms of numbers of families?

Mr Varney: We think that the combination of measures which have been announced will lead to a reduction of about one-third in overpayments. That of course will not take place until all the measures come into effect. This is one of the issues about the nature of tax credits. It does take time for these changes to play their way through.

Q27 Helen Goodman: Well, I was also going to ask you why will it not be possible to allow for income rises of up to £25,000 in the current year and implement those new levels from April 2006 instead of from April 2007?

Mr Gray: I think we are talking about this in relation to the income rises which apply to 2006–07.

Q28 Helen Goodman: You are talking about the changes in income in 2006–07 so you will be reassessing people from April 2006.

Mr Gray: Yes.

Q29 Helen Goodman: But because of this very big problem it would have a lot of advantages if you could pull it back a year. What I am asking is why cannot you pull it back and in the repayments that you make after the end of this financial year use the higher £25,000 figure?

Mr Varney: I do not think we are the right people to ask. We have to implement the system. What we would say from the system point of view is that it is an annual system and changes are most likely to be easier to explain, communicate and implement if you are doing it on an annual basis. These are not our decisions.

Q30 Helen Goodman: Sorry, are you saying that there would be no practical problem with introducing the change a year earlier?

Mr Varney: No I am not. I am saying that we would have to go back and recalculate quite a lot of stuff. We would have to really pull back. I suppose it is a policy decision about when is it best to put a date and when is it best to communicate it.

Mr Gray: Operationally it is undoubtedly a lot more difficult to implement a significant change of that sort when you are almost three-quarters of the way through the year when all our communications and all our actions up to this point during the year and response to people notifying us of changes of income have been on the existing basis.

Q31 Helen Goodman: So there is a time lag for making changes to the system of over 12 months; is that what you are really telling us? Is that correct?

Mr Gray: What I am really saying is when you are operating a system which is clearly focused around annual 12 month periods, not a fixed period system, that to introduce a change of a parameter like that when you are well through the year in question is potentially disruptive and administratively difficult.

Q32 Helen Goodman: What further steps are you taking to reduce fraud on the Tax Credits system?

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Mr Varney: We have got a very active process. We have got to take the view and we have taken the view that Tax Credits is going to be a target for fraud so we have got quite a comprehensive attempt to try and catch that fraud. We know that in the nature of these benefits that they will be subject to fraud so we keep them under constant review. Our underlying assumption is that we are working in a world where there will be attempts to defraud the Exchequer. We have got quite a sophisticated scheme for doing that. My problem in describing it to you in detail is that there is an audience outside that would love to know what it is.

Q33 Helen Goodman: I appreciate that. Can I just move on to the question of PAYE.

Mr Varney: Yes, sure.

Q34 Helen Goodman: You estimate that taxpayers are not receiving nearly £300 million a year. Are you going to inform taxpayers of this?

Mr Varney: We do. I think, as I have said in answer to the Chairman, we are going to try and make some system changes, but we do encourage people to check their tax returns and to think about and reflect on whether the charge is appropriate. I am the first to recognise that we have got to make that easier to do and easier to understand but there is a responsibility also on the taxpayer, and there has been a lot of publicity about what has happened with PAYE and a lot of advice in newspapers to people who are taxpayers to check whether they think their coding is correct, whether they think they have been overcharged. I would observe that if you look at the net figures on a net basis we have failed to collect net tax.

Q35 Helen Goodman: Are you suggesting that is a defence?

Mr Varney: No, I am suggesting that you have to have a balance in this. I know the distributional argument. I am not pleased where we find ourselves but the net result is that more people will get letters asking for tax to be paid rather than this great bonanza round the corner waiting for them.

Q36 Helen Goodman: What I do not quite understand is how it can be that you can make an estimate like this and not at the same time inform the taxpayers of the overpayments.

Mr Varney: Let me explain. We have a problem with about 40 million people in the Pay As You Earn envelope. We have a group of social scientists and statisticians who take a sample test to make it representative and on that basis we make judgments. So we have not gone through all 40 million cases. What we have done is take a select group of people who have got more than one return and done statistical and scientific research.

Helen Goodman: Thank you very much.

Chairman: Thank you. Greg Clark?

Q37 Greg Clark: Could we return to this issue of the disregard. Perhaps we can turn to page 15, paragraph 2.10 of the Report. The statement in

the middle of that paragraph says that: "The Department estimated that the final entitlement to Tax Credits in 2003–04 would have been about £800 million lower without the £2,500 'disregard'." Given that the disregard has gone up to £25,000 it should be possible to make an estimate just as you did last time. What is the estimate of the consequence specifically of the increase in the disregard?

Mr Gray: It is actually rather difficult to assess this precisely. The reason that we were able to make the estimate in relation to the £2,500 disregard was obviously we had been collecting information about those cases and judging whether or not that disregard should be applied in looking forward at a time when we are also changing a number of the other parameters in the system.

Q38 Greg Clark: I do not understand this at all. If it was possible to make an estimate of what £2,500 would cost, why is it not possible for £25,000? Are you saying that no estimate was made within the Treasury of the cost of this increase? I find that bizarre.

Mr Gray: No, I am not saying that.

Q39 Greg Clark: So it was made? Could you tell me what it was?

Mr Gray: I am saying a number of changes have been introduced simultaneously all coming in at rather different times and what the Pre-Budget Report gave—

Q40 Greg Clark: Mr Gray, I am aware of what the Pre-Budget Report gave and there was an opportunity to question that in the House of Commons. Now we have an opportunity in more detail to look at the components of that. Clearly one of the components, amongst all the different changes, is the fiscal effect of increasing the disregard. You have told me that there was an assessment made in the Treasury of that particular component. Could you tell the Committee what that figure is?

Mr Gray: I do not have the precise figures for each of the components and part of the difficulty is just costing that element in isolation, in that a number of the other changes—

Q41 Greg Clark: I am aware that you would rather set it in context but I am interested in what the specific component is. Since we know it is £800 million for £2,500 and if we have a ten-fold increase, would it be fair to say it would be £8 billion?

Mr Varney: No.

Q42 Greg Clark: So it is less than £8 billion?

Mr Varney: I think the point Paul is trying to communicate is that there was a series of changes and those changes will change the nature of estimating what the impact of this is on the situation before. What the Treasury have released, as I understand, in the Pre-Budget Report is what Mr Gray—

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Q43 Greg Clark: Mr Varney, we are not making any progress here. I am quite aware of all the changes in the Pre-Budget Report but in order to produce the Pre-Budget Report these various components must have been costed. Are you saying there was no assessment made of the cost of each of these components, Mr Gray?

Mr Gray: I am not saying that. I am saying—

Q44 Greg Clark: Right, that is clear.

Mr Gray: Colleagues sought to cost the overall package including taking account of some complex interactions between the way in which the different changes impacted on each other.

Q45 Greg Clark: Of course part of that assessment must have been an idea of what the pure fiscal effect was of increasing the disregard? That is surely correct. That work must have been done; you will confirm that?

Mr Gray: I believe it has been done. At the same time given the other changes to the system the impact of increasing the disregard is moderated and offset by quite a number of other changes.

Q46 Greg Clark: I am sure none of us has any problem with accepting that there are countervailing pressures but we want to disaggregate it and we want to understand what that effect is so we can understand it. Of course the work has been done. It would be astonishing if it had not been. The Treasury has higher standards than that. To help the Committee can you tell us what your estimate of that component is? We have the £800 million for £2,500, to increase from £2,500 what has your work told you the pure component of that is?

Mr Gray: We are not in a position to do that today.

Q47 Greg Clark: Why, because you do not want to give the information or because you do not have the information?

Mr Gray: I do not have the information in front of me. We will see what we can do and write to the Committee.¹

Q48 Greg Clark: You are the official responsible for this work as I understand it?

Mr Varney: No, the Treasury is responsible—

Q49 Greg Clark: I am asking these questions of Mr Gray.

Mr Varney: And I am just answering. I can as the Accounting Officer answer the Committee.

Q50 Chairman: Actually you can ask that question of the Treasury while they are sitting here.

Mr Athow: The difficulty with taking the £800 million figure is that it relates to 2003–04 and, as Mr Varney and Mr Gray have already said, in 2003–04 there were some specific circumstances that led to the pattern of overpayments, the underlying reasons for those overpayments being fundamentally different to what they will be going forward.

Q51 Greg Clark: That is entirely understood. In an earlier answer Mr Gray made clear this assessment has taken place within the Treasury. I am keen to find out what that component is. Mr Gray does not have the exact figure with him but if he had been involved in the assessment I assume he has some feel of whether it is £8 billion or some fraction of that and broadly what fraction it is. So, Mr Gray, can I ask given your experience of this and your involvement in this, broadly what order of magnitude is this figure; is it £8 billion or is it much closer to £800 million?

Mr Gray: It is a very great deal less than £8 billion.

Q52 Greg Clark: Half the £8 billion?

Mr Gray: No, it would not be as much as that. The distribution of income rises will be heavily concentrated at the lower end and the higher the threshold is raised the fewer increases are brought in.

Q53 Greg Clark: This is the reason for my question.

It is not a rhetorical question. I assume exactly as you say that income increases are distributed and more increases are clustered at below £2,500 than above. I suspect it was not £8 billion but the fact that you are aware there is a distribution means that there is a sum that you can exercise professional judgment on to guide us. What is it, or to put it another way, how steep is the distribution curve?

Mr Gray: What we are undoubtedly talking about is figures that can be measured in a few hundreds of million pounds for each of the components of this package. When you bring them all together you get the figures you have already seen from the Pre-Budget Report documentation. That nets out to figures of £100 million and £200 million over the years. Each of the components will have rather bigger effects than if viewed on their own but they have not been implemented.

Q54 Greg Clark: I understand the netting out. I am interested to know the individual components. You have been helpful in indicating that it is several hundreds of millions. Since that information is available would you write to me through the Committee giving what the assessment is of the pure component of increasing the disregard?

Mr Gray: Certainly in liaison with our Treasury colleagues we will write to the Committee.

Q55 Greg Clark: Providing that information?

Mr Gray: Yes.

Q56 Greg Clark: Thank you very much. In terms of the figures on overpayments obviously the current figures are disappointing. When do you think the level of overpayments will fall within acceptable limits, Mr Varney?

Mr Varney: What would you regard as acceptable limits?

Q57 Greg Clark: Can I ask you what limits would you regard as acceptable?

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Mr Varney: I think what we have said is the package that is put by the PMG reduces them by about one-third and I think we would like to see that that is achieved. Overpayments are part of the system. I think we have seen quite a confusion in the reporting which has tended to lead to a view that all overpayments are errors. That is just not correct; it is part of the system.

Q58 Greg Clark: Absolutely.

Mr Varney: I would have thought the approximate aim in the near term would be to see whether this package delivers the one-third reduction in overpayments that it has been targeted to achieve.

Q59 Greg Clark: I quite agree that it is intrinsically part of the system for better or for worse. Is there a figure that you would regard as acceptable given that it is inevitable?

Mr Varney: I think what we are going to continue to do is to learn what happens as a response to the Pre-Budget Report because that is a combination, of course, of an increase in the disregard, which you have rightly focused on, but also of clearer obligations in terms of the provision of information and a faster turn around of information and we want to see whether those together with PMG package deliver the sorts of results and improvement that we want to see in this system.

Q60 Greg Clark: Thank you, Mr Varney. In terms of the consequences of overpayment, paragraph 2.32 of the Report makes it clear that the Department recognises the pain and the distress that is caused to individuals. Is it not the case that it pushes people into debt and that debt has very severe consequence for people? It can cause family breakdown, it can involve consequences for health care. Has there been any study undertaken in the Department or more broadly in the Treasury as to the wider effects of overpayment resulting in people's financial circumstance being chaotic?

Mr Varney: Let me first of all apologise for the overpayment problems that have been caused by the computer system and some of the consequences of us not getting the system delivered in the way we would like to see it being delivered. I think there is quite a lot of research, not least amongst the voluntary sector, of areas where there have been particular problems. There has been an overall assessment of the impact of new Tax Credits in terms of the benefits of the policy, its high take-up and its impact on welfare and the economy at large. We have put in place policies for dealing with hardship.

Q61 Greg Clark: Has there been an assessment made of the broader aspects of hardship? Has there been a specific study undertaken?

Mr Varney: I think there has been quite a lot done by the voluntary associations. I have not seen anything on the economics specifically. We are in the process of reviewing COP 26 which is our code of practice guidance, dealing with overpayments together with the voluntary sector, and that was one of the commitments we entered into.

Q62 Greg Clark: Just in terms of the wider growth of means testing, obviously it is not just in your Department but it is in the DWP, for example, that some of these issues will arise. Has there been contact between the officer that has been appointed in your Department to address these issues with a similar official in DWP to make sure that the lessons are learned across both Departments?

Mr Varney: Yes, we had a meeting the other day at Management Board level of the two Departments. We do quite a lot of operations together and we try to learn from each other's successes and shortcomings.

Chairman: Thank you very much. Sadiq Khan?

Q63 Mr Khan: Can I apologise that I have to leave after my questions; no discourtesy intended. You will have seen the Report prepared by the Committee in September and you are implementing some of the recommendations. Clearly the Pre-Budget Report is quite fresh and you have talked about when the recommendations are going to be implemented. Therefore is it not necessarily so that your answers are going to be provisional and quite a lot of what you are talking about is work in progress?

Mr Varney: I think the whole spirit of the changes reflects the fact that this is a new way of delivering economic assistance and we are learning what works well, where there are difficulties, how we can improve it. We are on a journey of continuous improvement, and I do not think that is going to stop. I think there will be more continuous improvement. There is not a silver bullet. We are dealing with a society, as you know probably better than I, that will change and present different challenges.

Q64 Mr Khan: The numbers are staggering, are they not? In my constituency, as I understand it, about 10,000 people receive Tax Credits and across the country that is six million families and ten million children, so by definition it is large numbers?

Mr Varney: It has been the most successful uptake of a benefit delivered through a credit system that there has been. The take-up has been much higher.

Q65 Mr Khan: The Chairman raised this in introduction but are not overpayments inherent in the Tax Credit system because of the way the awards are provisional and based on incomes in the previous year?

Mr Varney: Yes, the change in the disregard and the obligations on people to keep us informed earlier and the shorter time window, should all help in trying to help reduce the overpayments but there will still be overpayments.

Q66 Mr Khan: Because of the way the system is designed overpayments are inevitable and inherent and what are some of the advantages of having the system designed in the way that it is? That is clearly one of the disadvantages.

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Mr Varney: I think one of the clear advantages is take-up has been at an all-time high. 6.1 million families are in receipt of the benefit.

Mr Gray: And there is an opportunity if there are changes in family circumstances, whether in relation to work or numbers of children or whatever, to be able to adjust the awards in a flexible way from the point when that happens.

Q67 Mr Khan: Okay, in answer to one of the previous questions, Mr Varney, you explained and made it clear that your job is to implement the policy and the legislation that we pass and some of the questions are clearly appropriate for other people and not for you. Can you give an indication of how helpful the announcements made by the Chancellor in his Pre-Budget Report are to the job you are seeking to do? Do you welcome all the announcements?

Mr Varney: Broadly what we have been doing is trying to look at the operational implications of the announcement, working with the Treasury to show the consequences of what policy changes they might be thinking about in terms of the administrative challenge and the communications challenge. We have worked very closely with them and this is part of the new division between Revenue & Customs and the Treasury. We have moved our tax policy people over into the Treasury and we concentrate on delivering effectively what the policy is and commenting on the implications of that policy for the way we conduct our operations.

Q68 Mr Khan: I welcome that teamwork but one of the things that initially concerned me, and maybe you can deal with this, is one of the measures announced was that claimants would have to report changes in their circumstances within one month rather than three. How confident are you that claimants will be able to deal with the change from three months to one month? More importantly, how confident are you yourselves in dealing with notifications?

Mr Varney: I think the key thing is communicating this. We will prepare for it and I think we have got notice of what the requirement is. In practice, if we can get to a system where the responsiveness works and where these changes are communicated we will have fewer worried people coming in to find out what their situation is and also it should have an impact on the amount of overpayment and underpayment. We should be able to respond rather faster. I recognise we have got a big communications challenge.

Q69 Mr Khan: Presumably there will be a big publicity blitz to make sure people are aware of the change from three months to one months?

Mr Varney: Yes there will.

Q70 Mr Khan: Can I ask you about two things. One is we heard last week when the DWP were here that the complexity of welfare benefits was clearly a deterrent, for example, to the elderly in applying for benefits. Can I ask you whether you think there is a

risk of people being scared to apply for tax credits because of stories they have heard about people falling into debt?

Mr Varney: There is some anecdotal evidence that that happens. I think first of all the overall statistics of take-up are very high. Secondly, I think the changes that have been designed have been designed to make the system work more sympathetically. I think our job is to sell those changes, but there will from time to time be such cases. All we can say at the moment is if you look at absolute statistics less people have been deterred than have been deterred from applying for other traditional benefits.

Q71 Mr Khan: You will have seen, I am sure, the publicity around the concerns surrounding fraud in the last couple of days. Can you in answer to give us an update of what is happening with the concerns raised by some of the staff deal with this balancing exercise? On the one hand, I would assume you are trying to make it easier to claim Tax Credits but the paradox of that is obviously that it is more susceptible to fraud because, for example making it possible to apply by telephone or the Internet would mean, I assume, less checks than would otherwise be the case. Can you tell us how you are balancing the need and aspiration to make it easier to apply for Tax Credits whilst at the same time trying to reduce fraud?

Mr Varney: Could I deal with the DWP issue. Let me say first of all that this is not a new tax credits issue, this is an issue about identity fraud, and what we have is the hijacking of 13,000 identities in a particularly virulent way, so what has been captured is data about those individuals which is really quite potent when you come to apply to a system and you present that false identity. There are quite a lot of aspects about it which are challenging. We have always looked at the e-portal as making this balance that you have rightly described between accessibility and control of fraud. We keep a pretty active eye on the extent to which there are attempts at fraud. As I said to Helen, we have got quite a lot of deterrents in that. We have quite a lot of joint working between ourselves and the DWP because the people who attack our systems attack theirs and the people who attack their systems attack ours. Some of it is organised crime. We became aware that there were cases which involved identities which had been hijacked. As we got into looking at that problem we found there were more people involved. We had already been concerned about the extent of the attack on the e-portal and this really tipped us over to the point where we felt the balance had shifted from being in favour of accessibility to being quite a severe fraud risk. Having said that, at this point in time, we have managed to stop the majority of the attempts. We have only been able to look at a small number of the total 13,000 cases that were hijacked but we have stopped the majority of cases getting through our fraud screening. On all of our e-enablements, for exactly the point you have made, and the same with the telephone, we have to worry about whether our fraud defences are strong enough.

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Mr Khan: Thank you, Chairman.

Chairman: Thank you very much. Stephen Williams?

Q72 Stephen Williams: Mr Khan has asked some of the questions I was going to ask about the new rules but one of the knock-on effects, I suppose, of the change in the notification period for a change in circumstances down from three months to one month must be that you are hoping to make more in-year recoveries; is that right?

Mr Gray: What we are hoping will happen is that we get changes of circumstances notified more quickly and therefore we can adjust the rates of payment more quickly and there is therefore less build up of overpayments or underpayments in that period. So that is certainly one of the priorities, yes.

Q73 Stephen Williams: What is the current split between overpayments that are corrected within the year and overpayments that are corrected at the tax year end?

Mr Gray: I do not have the precise figures for that. At the moment what we are seeking to do is if we are notified about changes of circumstances in year, we will seek to start the recovery process during the year. One of the other elements in the package that the Chancellor announced has of course been to change, with effect from next November, the rate at which in-year recoveries are made so that they are at the same rate rather than at a higher rate than the rate of recovery in later years.

Mr Jones: I can add to Mr Gray's answer and give you some figures, Mr Williams. When we finalised the 2003–04 overpayments, we arrived at debt showing in our accounts from those overpayments of net £1.6 billion. That was made up of £1.3 billion arising from 2003–04 finalisations plus £0.9 billion arising from changes of circumstances already notified by 1 April 2004, less £0.6 billion recovered in 2004–05, so that £0.9 billion to £1.3 billion gives you a rough indication of the split.

Q74 Stephen Williams: I was led to believe that the Department does not routinely keep such a split of statistics as I asked for. Is that correct?

Mr Gray: Does not?

Q75 Stephen Williams: Yes.

Mr Gray: The figures that Mr Jones has given you relate to the overall flows of money. I thought what you were asking was in relation to the numbers of individuals which we are tracking at the time. It is much more difficult for us to track that than the end of year reconciliation from the monetary values.

Q76 Stephen Williams: Can I switch to the overall burden on Revenue & Customs resulting from all the problems with Tax Credits. How many staff resources have you had to deploy in order to deal with Tax Credits? Has there been a deployment within the Department or other parts of the Civil Service?

Mr Varney: Yes, can I just say we do naturally shift staff around to reflect where we see changing risk and changing issues and we expect to do that. We

have obviously put in resources, both in terms of call centre ability and also in terms of compliance and in terms of service provision. Paul, do you have a number?

Mr Gray: Broadly speaking, the total number of staff on average engaged in supporting tax credits is between 7,000 and 8,000. The particular area in which we have flexibly deployed extra resource at times of pressure has been in our contact centre business where we have dedicated centres dealing with tax credit queries but we also have some other contact centres that are capable of dealing both with general tax enquiries and tax credit enquiries and we seek to flex up resource in response to expected levels of demand.

Q77 Stephen Williams: You said that was extra resource. Was that redeployed resource already existing or additional resource you had to recruit into call centres?

Mr Gray: It was a bit of both. Predominantly it was redeployment of existing staff but we have, both in relation to contact centres and in relation to the back room processing work, taken on additional staff, predominantly on fixed-term appointments, in order to deal with the peaks of work.

Q78 Stephen Williams: What I am trying to get at is whether other parts of the service that you offer to taxpayers have suffered because you have had to move staff around in the Department? You are saying it is natural for the organisation to move staff around but the scale of this I would suggest is not natural; it is a major fire-fighting exercise.

Mr Varney: No we have undoubtedly got concerns about whether we have exposed risks in other places and I think, with the benefit of hindsight, we would have been a bit more conservative with some of the resources of pay as you earn, but the use of fixed-term contracts is useful for us when it comes to peak loads which are going to be relatively transitory (we hope).

Q79 Stephen Williams: Okay. There are various changes coming through in the next year or so as a result of the Chancellor's announcements. Are you going to have to have recruit extra staff in order to implement those?

Mr Varney: No.

Q80 Stephen Williams: Chairman, is it permissible to ask questions about fraud as I missed the first few minutes of the meeting? As I understand it, it was on 2 December that the e-portal was shut down and the Revenue said that they did this as soon as they noticed there was a fraud taking place, but I have been led to believe there were media reports about the existence of fraud in the system as far back as October so why did it take until 2 December before you took the decision to shut down the e-portal?

Mr Varney: As I think I said in answer to your colleague Sadiq Khan, we were watching the level of transactions going throughout the e-portal. We have had it under increased scrutiny since the early part of the summer. We are making this balance between

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access and risk and we saw the risk starting to rise but we thought we had it under control. These identity frauds tripped us over, they were really the catalyst to say we were going down the road towards closure and we needed to accelerate it because this was a really virulent form of fraud in the way that it presents itself to the system. The combination of details that the fraudsters had meant that we had to think very carefully about the filters that we have got in place.

Q81 Stephen Williams: You say you cannot measure the risk of this but if you look at the telephone, is there a different level of risk in people who use the telephone part of the service versus the Internet?

Mr Varney: In all of our systems for each channel there are different and particular risks. What we try and do is have a framework to deal with those risks to make sure that we make it as difficult as possible. We are in a very early stage of knowing what the full extent of dealing with this fraud is.

Q82 Stephen Williams: Are you confident at the moment that there are no threats in the pipeline to the telephone service?

Mr Varney: We closed the system because of two things. The nature of this fraud that we have seen so far—and it is very early days—is we are not seeing a collecting account. We often see a single bank account with many names and that is not what we are seeing at the moment. Clearly we have to find out how the accounts are linked and we will have to reflect on that and then see what have been the other implications of this theft of identity.

Q83 Stephen Williams: In response to a Parliamentary Question (which for the record is question reference 2076) it was said that there have been 260 prosecutions since 2003. I accept you might not know the answer off the top of your head but are they individuals or would some of those prosecutions include criminal gangs?

Mr Varney: I think both. We have successfully prosecuted 137 cases. Some of them were organised fraud, some of them were individuals, and we have an internal structure, the focal point of which goes by the exciting name Tax Credits Organised Fraud Strategy Board. That is the master body that oversees all the reports and activities that we get about fraud and, as I say, we work quite closely with DWP because we are both likely to be the target of fraudsters.

Q84 Stephen Williams: One final point. The person who is in the news for being arrested yesterday I understand was only found because he was trying to use a false passport rather than some problem with his Tax Credits. Would you like to comment on that?

Mr Varney: We have a risk framework which tries to be comprehensive. I am pleased that somebody who has tried to defraud the Exchequer is paying the price and it should deter people from doing it.

Stephen Williams: Thank you.

Chairman: Thank you very much. Mr Bacon?

Q85 Mr Bacon: Mr Varney, could you turn to paragraph 2.44 please. You will see there it says: “The Department have evidence that Tax Credits have been targeted by organised criminals . . .” but continues “The Department’s Internal Audit Office concluded that there was a lack of comprehensive information to allow a robust analysis of the problem.” That was basically what you said to Mr Williams in your earlier answer. Mr Williams said to you that there was knowledge of the problem of organised criminals as early as October but it was earlier than that, was it not?

Mr Varney: On the knowledge that there was an attempt, as I think I have tried to say, we recognise what is in the Report, we try to make a balance between accessibility—

Q86 Mr Bacon: I am just trying to get to the date. When did you first know there was an attempt by organised criminals to target the Tax Credit system?

Mr Varney: There are lots of attempts and probably from the first day that Tax Credits started it was a target for organised criminals. Our working assumption was that we would be the target of attack.

Q87 Mr Bacon: Can you say what it is about the nature of the processing once an identity has been stolen, and the national insurance number and date of birth have been stolen and used and the application is received, if it is a manual application, what is it that is different about the way it is then processed compared with an on-line application? Anything? Is there something different about the way it is processed when it comes in through an on-line application compared to a manual one or once it is received are they in essence dealt with in the same way?

Mr Varney: They are broadly the same.

Q88 Mr Bacon: So the risk is not just the on-line portal; the risk is to any application potentially?

Mr Varney: Yes. What we try and do is to run a general risk framework and then see if there are particular risks which come through particular channels or portals. I think the answer to your question is that they are broadly similar.

Q89 Mr Bacon: What is your estimate of the amount of money that you have lost through organised or other criminal activities?

Mr Varney: Our losses to date in terms of organised fraud are running at about £15 million.²

Q90 Mr Bacon: £15 million in total?

Mr Varney: In total.

Q91 Mr Bacon: When you say “organised fraud” do you mean from organised criminal gangs?

² *Note by witness:* This figure relates to the losses to date in some 25 cases of significant organised fraud (ie those involving more than £25,000) currently under investigation. As a result of the further work on tackling organised fraud, we believe that the £15 million figure will increase, but it is too early to give a firm estimate at the moment.

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Mr Varney: Yes.

Q92 Mr Bacon: What about other criminal fraud?

Mr Varney: We have individual cases under investigation. The losses to date for individuals is £1,500,000.

Q93 Mr Bacon: These 13,000 cases that Mr Khan referred to earlier started off when the Public and Commercial Services Union referred to them as being 1,300. It rapidly became 13,000. Do you have any reason to know that this number has gone up still further? I have seen 15,000 in the press. Which is it?

Mr Varney: The number to the best of our knowledge is 13,000 because a particular list was passed over with these individuals on, so we have been able to identify that—

Q94 Mr Bacon: But there could be other lists that you do not know about?

Mr Varney: Yes. I have just been given advice so that I do not mislead you. The numbers that I have given you are about organised frauds. They are not all frauds.

Q95 Mr Bacon: I want the number for criminal activity.

Mr Varney: It is all criminal activity.

Q96 Mr Bacon: Not if it is error.

Mr Varney: Not if it is error.

Q97 Mr Bacon: If you write to my constituent saying she owes you £36,000 when she has shown me a bank statement saying that she has been paid £3,600 by you, that is not criminal activity on her part. It is an error by you.

Mr Varney: I fully accept that. I was just trying to ensure that the information I gave you was correct.

Q98 Mr Bacon: Could you say, Mr Varney, if the administration of the Tax Credit scheme has been effective, efficient and economic?

Mr Varney: I think it has been effective in terms of the number of people who have come into the scheme.

Q99 Mr Bacon: I was asking about the administration of the scheme.

Mr Varney: I was trying to answer. If you look at the cost of the scheme, it has been broadly about 3p in the pound for every pound that is paid out. If you look at other schemes which provide economic benefit it has been reasonably efficient. Has it been as effective as it should have been? No, it has not and that is why on frequent occasions when I have been in front of select committees I have apologised for falling short of the standards we set ourselves.

Q100 Mr Bacon: You cannot account to Parliament for how the money that Parliament has authorised has been spent, can you? That is why the C&AG has felt compelled to put a qualified opinion against the trust statements of the Inland Revenue.

Mr Varney: As I said before, I regret that but we are working, and I have explained what we are trying to do, in order to target the reduction of the errors in full.

Q101 Mr Bacon: Sir John, if the NAO feels obliged to place a qualified opinion against the accounts because of the amount that is unaccountable for, literally, could you say that the administration of the scheme at the time of the review could possibly be effective, efficient and economic?

Sir John Bourn: It could not. The whole point of placing a qualified opinion in those circumstances is to point up its ineffectiveness.

Q102 Mr Bacon: Have you ever sought a direction, Mr Varney, from ministers as an accounting officer?

Mr Varney: No, not yet.

Q103 Mr Bacon: You are familiar with this document, *The responsibilities of an Accounting Officer?*

Mr Varney: Yes.

Q104 Mr Bacon: You probably recall that in one of our previous Reports we referred to the possibility of accounting officers issuing directions in relation to Tax Credits.

Mr Varney: No, we do not.

Q105 Mr Bacon: You do not? Oh, well, let me find it for you.

Mr Varney: I do know that in one of the reports on Tax Credits there was a general point that drew attention—

Q106 Mr Bacon: Let me help you out by referring to it specifically. This was the PAC Report—

Mr Varney: December.

Q107 Mr Bacon:— the fifth Report and your minutes in response, in which the PAC conclusion was that accounting officers should see that ministers are made aware of the risks presented by unduly complex schemes and, if necessary, be ready to seek ministerial direction where such schemes would be hard to implement to an acceptable standard. You have already said you were falling below your own standards. The Department's response was, "The Department does not believe that the Tax Credit scheme was unduly complex". In answer to an earlier question you said, and I wrote it down at the time, "We still do not feel we know enough about the system. It is a very complicated system", and yet, "The department does not believe that the Tax Credit scheme was unduly complex". Which is it? Is it unduly complex or not?

Mr Varney: Shall I make it simple for you? It was the computer system I was talking about. The quote was about the computer system.

Q108 Mr Bacon: The computer system affects people, does it not?

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Mr Varney: As I have said, we have stabilised the computer system and it is fragile. We have done three major releases, one of which is one of the biggest in Europe, and it is stable.

Q109 Mr Bacon: Its size in Europe is not something that is particularly impressive. Most of the large computer failures tend to be in very large computer schemes. Your job as accounting officer is to account for how you spend money to Parliament. You are unable to do that satisfactorily at the moment. You say yourself you have fallen below your own high standards. The NAO says that they have issued a qualified opinion because the administration of this scheme is not effective, efficient and economic. You are trying to get it right. When will you get right by?

Mr Varney: As I said, what we have got to do is measure the errors and fraud in the system, which is what we are doing. I recognise your impatience, and it is probably at least as great as mine, to get those results. That will enable us to target the reduction programme which we will then share with the NAO.

Q110 Mr Bacon: You see, not only are you failing in your duty to Parliament to account for how you spend public money but you cannot even tell us by what date you will be able to account for how you spend public money.

Mr Varney: I might just get credit for saying the same thing as I said last year, which is that it will take us until the spring of 2006, for the reasons I explained, to get the target sorted out and a plan agreed with the NAO.

Q111 Mr Bacon: So far £40–£45 billion—I think it is £40 billion at the moment and will be £45 billion by next April—has been spent on the Tax Credits programme. Is that public expenditure?

Mr Varney: I do not understand.

Q112 Mr Bacon: Are Tax Credit payments public expenditure?

Mr Varney: Clearly.

Q113 Mr Bacon: Clearly they are, yes. That is interesting to hear because Sir Nick Montagu sat where you are sitting now and vehemently denied that they were public expenditure. Sir John, is it possible you could confirm that in your view Tax Credit payments are public expenditure?

Sir John Bourn: I think that up to now technically Mr Varney is right; of course, in the real world they are public expenditure, but I think in terms of how they are analysed they do not count as public expenditure because they count, as it were, as tax allowances, so in that sense they do not count, but I think the Treasury would be able to give a definitive view on that.

Ms Diggle: Perhaps we can clarify that.

Mr Athow: They are split between an element of tax foregone and an element of public expenditure and this is based on internationally agreed principles for setting out the national accounts treatment of these sorts of Tax Credits.

Q114 Mr Bacon: Mr Varney, could I return to the subject of direction? What would be the circumstances which would cause you to seek a direction?

Mr Varney: Any of the circumstances in the blue book.

Q115 Mr Bacon: So if you thought that a scheme—and let me quote from the blue book—would “infringe the requirements of propriety or regularity” then you would seek a direction? That is what it says.

Mr Varney: Yes, that is what it says.

Q116 Mr Bacon: And you do not think that this scheme infringes the requirements of propriety and regularity?

Mr Varney: Clearly not.

Q117 Mr Bacon: Since Sir John has qualified the accounts of your department, clearly Sir John does think it infringes the requirements of propriety and regularity.

Ms Diggle: Perhaps I could help you here. “Propriety and regularity” mean acting as the law requires and as the estimates passed by this House require. It does not mean effectiveness as such.

Q118 Mr Bacon: No, I realise that. Regularity goes to things like fraud and error, does it not?

Ms Diggle: It does.

Q119 Mr Bacon: Sir John, when you qualified the opinion in the accounts can you say why you did so?

Sir John Bourn: It was because of the degree of error, but I take Mr Varney’s point. Because you have a degree of error and it leads to a qualification that does not mean that the accounting officer must necessarily seek a direction because that would then mean that every qualification meant that the accounting officer should have sought a direction and that is not what qualification means. It does not carry with it that necessary implication.

Q120 Mr Bacon: Not necessarily, but there must come a point surely when, if you are unable to pass a clean bill of health on a set of accounts, if it is prolonged for a period, one must conclude that the accounting officer is unable satisfy his responsibilities to Parliament.

Sir John Bourn: That would be right but, as Mr Varney said, he is working to be able to satisfy the requirements.

Q121 Mr Bacon: Mr Varney, could I ask you about the deal with EDS? I know you have written to the Committee and you prefer to talk about this in detail in private session which I think, Chairman, has been agreed to. Can I just ask you in broad outline terms—the reason why you want to have the discussion in confidence is that you have reached a contractual agreement with EDS as to the nature of the settlement. Is that right?

Mr Varney: Correct.

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Q122 Mr Bacon: So essentially the Public Administration Committee Chairman, when he wrote to the Chairman of this Committee, was right when he said that the confidentiality agreement may limit your ability to answer questions?

Mr Varney: It will not limit—

Q123 Mr Bacon: In public?

Mr Varney: Yes, with that qualification. There are some things that I can do in public. Can I be clear on what the limitations are, that is, what I cannot do in public? Would that be helpful?

Q124 Mr Bacon: Yes.

Mr Varney: There are two things. In the process of reaching this settlement EDS had to satisfy us about its future plans and the realism of those plans. Those involved revealing what contracts it thinks it will win and at what sort of price, so I do not think we can answer questions on those because in a public session that would confer commercial advantage on EDS's competitors that they could not gain in any other way. The second issue is that we have retained the right to sue EDS if they breach the settlement agreement, and of the settlement of £71¼ million, which I will just observe in passing is the largest settlement in this field, more than £44½ million has been paid.

Q125 Mr Bacon: More than £44½ million has been paid?

Mr Varney: Paid already.

Q126 Mr Bacon: Already in cash to you as a payment?

Mr Varney: As cash or the equivalent of cash.

Q127 Mr Bacon: What, you mean they have given you some of their Government bonds?

Mr Varney: No, I do not think we got any of those. There are two elements in the contract which I am quite happy to talk about in private session if I may. Can I just leave it that they are cash but we will explain what they are? If we have to sue at a future date we would be put at enormous disadvantage if today I had to lay bare in public our litigation tactics or any part of our lawyers' assessment of the strengths and weaknesses of our case against EDS, and our approach in the negotiations was to keep our powder dry on the merits of the case and focus instead on settling the quantum. In the closed session therefore I can speak more easily about the advice we have had from our lawyers, who strongly recommended acceptance of the £71¼ million.

Q128 Mr Bacon: I am not going to ask any further questions about that. I just want to ask the Treasury on the question of fraud, have any lessons from the fraud with the portal being closed recently that are useful for other Departments been passed on by the Treasury through guidance to other departments?

Ms Diggle: At this stage that is not something we can do because the Revenue and Customs are still looking at the threat and what has happened, but if there are messages that can be passed on it is something we would be eager to do.

Q129 Mr Bacon: Have you put out guidance on confidentiality clauses in the settlements of IT companies in the way that you have done in the past for settlement payments to individual employers in public service?

Ms Diggle: I am not aware of it.

Q130 Mr Bacon: Would you write to the Committee and let us know if you have?

Ms Diggle: Yes.³

Q131 Mr Williams: Mr Varney, we understand that you have landed in the middle of this and you are trying to deal with many things that arose before you took over your office but you understand that we have to ask the questions. In the light of your experience of this contract would you employ EDS again?

Mr Varney: Yes.

Q132 Mr Bacon: And would you give a reference to colleague Departmental heads?

Mr Varney: I do not think I would go quite as far as that.

Q133 Mr Williams: I see. It is generosity but not masochism?

Mr Varney: Is that the only choice I have got? Has it come to that? The reason is that although EDS did not do new Tax Credits well there are lots of things that they do do well. This was not their finest hour.

Q134 Mr Williams: Not their finest years.

Mr Varney: It may not be their finest century.

Q135 Mr Williams: It was not frontier technology, was it? They are not noted for frontier technology.

Mr Varney: I think EDS have gone away and looked at the performance of their operation. They have put new leadership into the UK business and I think they have changed the relationship with the US. I would be happier to talk about technology in private session because we can give you a much better answer if you are agreeable.

Q136 Mr Williams: Did you say they had changed their relationship with the US?

Mr Varney: The relationship between the UK subsidiary and the US has changed.

Q137 Mr Williams: They have always been proud of it. They used to operate in my constituency and they were always proud of the fact that the individual units would add an enormous degree of independence, so what difference does that make?

³ Ev 22–23

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Mr Varney: Clearly it was very successful and it is growing. That is a great symbiotic relationship. If you are paying out large monies in settlement, that relationship will undoubtedly change.

Q138 Mr Williams: In terms of the reclaims you have made on Tax Credits, we know there are large numbers of them. What about the scale of them? What is the largest reclaim you have had to make so far?

Mr Gray: It is in the £20,000s.

Q139 Mr Williams: £20,000?

Mr Varney: Individual cases.

Q140 Mr Williams: Are there many on that sort of scale?

Mr Gray: I think it is a relatively small number. I am not sure we can give it to you now but we could obviously let you have a precise figure later.⁴

Q141 Mr Williams: Perhaps you would let us have a note rather than waste time now. Jumping a bit, but it is relevant, on pay-as-you-earn the NAO tells us that taxpayers are not being advised of around £295 million repayable to them. Why not?

Mr Varney: This talks to an issue of multi-jobs. Pay As You Earn is our oldest system. It is a 60-year old designed system which generates about £108 billion a year. A targeted intervention by our internal audit department looked at how we handled people who had more than one job and whether we were tying them up to produce an account for the employee. That is not the way the system is structured. The system is structured around the employers. Based on a sample our view was that we had had net under-recoveries of £280 million; we had not claimed enough tax. Some people had overpaid by £295 million and we had given others too gracious an allowance so they had underpaid by £515 million.⁵ What it has highlighted is an issue for us about how we tie together people in different employments. There is an issue about—is that not clear?

Q142 Mr Williams: You are going into far too much detail. All I asked was why you are not notifying people that you owe them money.

Mr Varney: The way the system works is that there has been—

Q143 Mr Williams: I do not want to know the way the system works. I want to know, do you know? Let us ask the question a different way. Are you able to identify the people?

Mr Varney: No.

Q144 Mr Williams: Have you put as much effort into trying to identify the people who you owe money to as you have into identifying those people who owe money to you?

Mr Varney: Yes.

Q145 Mr Williams: You have?

Mr Varney: In neither case can we realistically go through the system for these individuals. We have to find a different way. That is why we are looking at the way the system is designed and the way in which we tie together individual cases.

Q146 Mr Williams: Have we any idea of the scale of this? I am talking about overpayments and so on. You say you cannot identify individuals. Does that mean you do not know the scale of what you may owe some individuals and you may owe unidentifiable individuals?

Mr Varney: I have an estimate based on the statistical analysis which tells me that there are two and a half million people involved in the overpayment and 1.3 million involved in the underpayment but I do not have their specific identity. Clearly, the publicity that has—

Q147 Mr Williams: Do you have the statistical information without their identity but in terms of range of non-repayment?

Mr Varney: No. I am a bit wary of getting too involved in this. We have taken a sample which we think is representative which has led to the estimate. We have not gone through a systematic look at each individual. This is not the end product of looking at the tax affairs of 3.8 million people in detail.

Q148 Mr Williams: It is no good going any further at the moment. I honestly do not see why you cannot do more than you are doing. Perhaps you would send us a detailed note.⁶ Coming back to the main subject of the Tax Credits, all the talk up to now has been about overpayments. That is why I was interested to see why you were not interested when you owed someone money. What about underpayments on the Tax Credits?

Mr Varney: There are underpayments.

Q149 Mr Williams: I have obviously missed the figures. What is the scale of the underpayments?

Mr Gray: I think I am right in saying that roughly speaking, of the number of Tax Credit recipients in the first year, for a little over half of them, 54%.

Q150 Mr Williams: How many in the first year?

Mr Gray: Of the total of six million families receiving Tax Credits in the first year, over a half of those, something like 54%, had neither an overpayment nor an underpayment. Roughly a third, 33%, ie, two million families, had an overpayment and roughly 13% had an underpayment.

Q151 Mr Williams: So you have these people who have been underpaid. What are you doing about paying them?

Mr Gray: Paying them as soon as we can.

⁴ Ev 21–22

⁵ *Note by witness:* The amount of tax underpaid was £575 million, not £515 million.

⁶ Ev 22

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Q152 Mr Williams: Unlike with Pay As You Earn, have you in this area been able to identify the people who have been underpaid?

Mr Varney: Yes.

Q153 Mr Williams: You are satisfied that you comprehend who they are and they are being paid?

Mr Gray: Yes.

Q154 Mr Williams: That is fine. Jumping back to the individual who owed you £20,000 under the tax credit reclaim system, how do you decide the rate of repayment for people? What factors do you take into account in saying, "You must pay next year or in two years"? How do you determine it?

Mr Gray: We have some basic formulae to which we operate. Depending on the category of case, for people who are on the maximum award we have one system, for people who are on the minimum family element of child credit only we have a rate of recovery, and then we have a rate for the rest. Those respectively are 10% for people who are on the maximum award, 100% for those on the minimum award and 25% for those in between. That has been the normal rate of recovery that we have applied in relation to future years.

Q155 Mr Williams: Does it take any account of the outgoings of the individual families?

Mr Gray: These are the normal rates we apply.

Q156 Mr Williams: That did not answer my question. Does it take into account the outgoings of families?

Mr Gray: Those formulae do not but we have an arrangement under which we make clear to people that if they feel that the rate of recovery we have asked them to make to us presents them with hardship they can come back to us, they can give us details of their outgoings and we can then enter into arrangements to agree a longer period, a slower rate of recovery, that will apply to them. We do that in relation both to ongoing awards, where we are obviously reducing the current level of award, or in relation to ceased awards where it is just a debt we are seeking to collect.

Mr Varney: I think it would be helpful if we tell you what we have had in quantum. At the end of September we had 164,000 time-to-pay arrangements in place across the whole population of the new Tax Credits, 143,000 for periods of 12 months and less, and 21,000 for periods exceeding 12 months.

Q157 Chairman: Mr Varney, you have requested that you answer some questions about your settlement with EDS in private so we will now move into private session.

Mr Varney: Thank you very much indeed, Chairman.

Q158 Chairman: We are now basing these questions on the letter that you sent to me, Mr Varney.

Mr Varney: Yes.

Q159 Chairman: The first question is, why settle for £71 million when your total loss could be as much as £209 million?

Mr Varney: The settlement is conditioned by the fact that there is a cap in our contract with EDS which operates to limit in a single event the liability of EDS to £31 million. Perhaps it would be helpful in going through if we explained what the negotiations were and how we got to this settlement. When I came in I inherited a situation in which there was a degree of conflict and the suggestion was made to us that we might have independent expert determination. We took a judge to do that for us who was knowledgeable in these matters and he came out with a finding which was favourable to us, (which was a surprise, I think, to EDS, given that we had taken a lot of EDS's advice). The evaluation said that there had been three potential events which could be the subject of claim. Some of those were under the £31 million cap. Some of them were over the £31 million cap, but in a court of law to enforce the contract we would be subject to the cap. EDS decided not to accept that expert finding and then we went into a process of negotiation which spread over many months, trying to get to a settlement. At the same time we prepared our court case and were prepared to go to court. We put our court case together. We then quantified the loss, which was the £209 million. We have a duty to mitigate that loss and the net loss came out at £104 million. We then had to think about what would be EDS's response, what would the court be likely to find, how much would it cost (and we can go into more detail of what that was), and against that background, together with my Executive Committee, I decided that the offer of £71¼ million was the best solution for the public purse.

Q160 Chairman: Is it fair to expect claimants to reimburse you for the £105 million of overpayments? After all, this is presumably down to EDS's mistakes. Why should the claimants have to reimburse you?

Mr Varney: There is a practical issue. We have a contract which has a cap in it. I think you are always going to have a cap because I do not think any private sector limited liability company is going to enter into an arrangement which has unlimited liability so the question is: what is the adequacy of the cap? The problem for the public sector, and in a sense it is the same for the commercial concern, is that if you get a bigger cap you are going to pay a heavier price. Nothing comes for free. The question therefore is how big is the cap, and then how easy is it—

Q161 Chairman: I can understand that. They are going to charge you more?

Mr Varney: Yes, because you are exposing them to a much greater degree of risk, which is your deliberate intention. The other issue is not just the cap but also the definition of what the courts will find about what is a single event because it has to be a single event of

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failure. Clearly, your contractor's first defence is going to be that there were no errors. Their second defence is going to be that these errors were linked and that what we assert as many causes of error is actually only one fundamental cause of error and therefore their liability is £31 million.

Q162 Chairman: You seem to have had quite mixed success in getting this money out of EDS. Could that be because a lot of these mistakes are down to you?

Mr Varney: No. I would put it the other way round. This is the biggest settlement of liability in this arena that we can find in the courts in the UK. I do not know whether the committee knows but we have not been able to find any settlement in the public sector of this order in a contract of this nature.

Q163 Chairman: One thing I found rather unpleasant about this is that a third of the £71 million depends on EDS getting new business from Government. Why should they get this new business?

Mr Varney: If they do not get it we will have to get the £71 million⁷ in another way. We have looked at their order book. They are bidding for a lot of contracts.

Mr Hartnett: They are bidding for nearly *** worth of work in the UK, but perhaps the bigger and more relevant issue here—

Q164 Mr Bacon: Did you say million?

Mr Hartnett: Billion.

Q165 Mr Bacon: Billion dollars?

Mr Hartnett: Yes. We saw the order book in dollars.

Q166 Mr Bacon: But it is their UK order book?

Mr Hartnett: Yes. That order book, both the past order book and the prospective order book, is about *** Government work.

Q167 Chairman: Can I ask if the Treasury endorses these arrangements?

Ms Diggle: On the facts that I have heard I have no problem with the kind of pragmatic settlement which was agreed.

Q168 Chairman: You approved the final settlement, did you?

Ms Diggle: I did not personally.

Q169 Chairman: The Treasury approved the final settlement?

Mr Varney: Yes. We did present it to the Treasury.

Q170 Mr Williams: Did they influence the shape of it?

Mr Varney: No. Our strategy was to maximise the cash. There is a practical constraint, which is that the people we are negotiating with have a share price which has done well but they are not in a great shape,

so there is a question of how much blood we can get out of them with cash. Under the terms of our contract at the last date they are able to offset increases in cost against the profit share and therefore, by the fact of making a settlement with us, we would have to pay back £11.3 million and they have waived the requirement to do that. We had a bill of theirs which was due and payable and which we had refused to pay, which was worth £2.4 million. If you add those three together that is the £44.7 million that I said we had received and that is why I used the phrase "as good as cash", because essentially it is into our system. The £26¹/₂ million will come from future business. They put to us that they wanted us to pay for services from them to that value. We did not want to pay for services from them, for the reasons we talked about in open session, because the requirements I have got I am not sure play to their strengths, but we did want to take a share of getting this and we were prepared to get it over three years. We satisfied ourselves that the prospective order book was capable of generating that amount of money. We satisfied ourselves that it would not influence the procurement decision by the British Government, that all procurements would have to be self-standing, but that we would get paid over the three years. If we do not get paid back, we retained the right to go back and reopen the whole case all over again.

Q171 Mr Williams: It is a mishmash of different elements. Are any of these elements of compensation that you will receive tax deductible themselves?

Mr Varney: I think EDS will themselves seek to present these to the tax authorities as taxable deductions. We have made no commitment one way or another about how we will respond to an individual taxpayer's affairs. That is a separate issue.

Q172 Mr Williams: Are we talking about the whole settlement or, if not, which bit of the settlement?

Mr Hartnett: There are four things to take account of, Mr Williams. The first is, is the payment made by way of penalty because that would prevent tax deduction? The answer to that is no. The sort of considerations that we apply here are, are these punitive damages or, secondly, is there a penalty of any sort, and the inspector responsible for dealing with EDS in the UK will think about that. The third thing the inspector will think about is, has any of this been covered by insurance recovery because that will be part of the factor of whether there is a tax deduction or not. The fourth is that we need to remember that the EDS Corporation in the United States has guaranteed this payment and was a guarantor under the contract under which we sued. The inspector will want to be sure that the payment being made here is wholly for the purposes of trade by EDS in the UK and not in part at least a mixed payment, partly for EDS UK, partly for EDS Corporation. There is a lot for the Inspector of Taxes and EDS to sort out together. We have made no commitments.

⁷ *Note by witness:* The £71 million figure refers to the amount (£71.25 million) agreed under the settlement. Of this, £44.7 million has been paid leaving a balance of just over £26.5 million outstanding.

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Q173 Mr Williams: Looking at it in the most beneficial way from the point of view of EDS, what is the maximum tax write-off they could get?

Mr Hartnett: The absolute maximum, if they met every test there was in the UK, would be 30%.

Q174 Mr Williams: 30%?

Mr Hartnett: But then any other—

Q175 Mr Williams: In cash terms?

Mr Hartnett: 71.25 times 30% feels like 22 million-ish. Can I just add this: any other business trading in the UK paying compensation, meeting the tests I mentioned, would also get a tax deduction.

Q176 Mr Williams: In part they stand to get a tax payback of some it and then part of it is contingent on them getting other government contracts. That seems a strange arrangement to enter into. It almost gives government an interest in their application, do you not think? How on earth was this one accepted?

Mr Varney: I plead guilty perhaps to taking rather seriously the idea that you want us to be more commercial. This is a commercial settlement aimed at maximising the amount of recompense that we receive.

Q177 Mr Williams: They have to have accepted that you are entitled to that recompense. What puzzles me is why you accepted that out of notional future earnings, not just future earnings in Britain but future earnings from government. I do not see the logic of that.

Mr Varney: It is not the case that we sat down and agreed it was going to be 71.25 million and then we worked out a way of how it was going to get there. We had a hard fought set of negotiations and my judgment, shared by my executive committee, was that this was most likely to get us to the maximum number. The advice we got from our lawyers, who we asked to look at the court case and work out what they thought was the likely settlement, was that we were justified in settling this on the basis of a cash element alone; anything we got above that was likely to be of greater benefit. It is a commercial construction aimed to go in the way in which EDS is likely to part with more money to us than any other route.

Q178 Mr Williams: Under the profit share arrangements you would have received 11 million anyhow.

Mr Varney: No.

Q179 Mr Williams: But now you have accepted that £11 million should be included in the £71 million.

Mr Varney: No, it is retrospective.

Q180 Mr Williams: That is what we were told in paragraph five of your letter. Why should it be included in the headline figure of £71.25 million?

Mr Hartnett: Mr Williams, can I unpack it for you? Whatever settlement EDS reached with us would be applied against the profit share for the last 15 months of our business with them. The profit share

was, if you like, a measure of super profit over a specified figure in the contract, then shared between EDS and ourselves, and we got over that figure. Compensation was set against that and it removed the super profit. It meant that we had to pay back £11.3 million. What we have done is rather than hand the £11.3 million to them, we have taken the £11.3 million and applied it to the contract. It has not technically been waived at all. Money that we owed them has been applied against the contract.

Q181 Mr Williams: In taking the money that way, do they then get the 11 million? Does that give them a tax write-off under the compensation arrangement that they would not previously have had?

Mr Hartnett: They get a deduction if they meet the tests that I mentioned to you earlier on. They get a deduction by reference to the gross figure of 71.25 million, if they meet the tests. If we had gone round the roundabout with the 11.3, we paid the 11.3 which we owed them because the profit share was reduced and then they would have given us back a cheque to apply against the settlement.

Q182 Mr Williams: It looks as if it is all a bit illusory, a presentational package.

Mr Varney: It is a very real sum of money.

Q183 Mr Williams: Yes, but for whom?

Mr Varney: Sorry?

Q184 Mr Williams: For which one?

Mr Varney: For the taxpayer.

Q185 Mr Williams: What about EDS?

Mr Varney: EDS are going to pay this across. This is money that is not going to flow to them. Can I make one other point because I think you have raised an interesting issue? I have been at pains to separate our tax gathering role from negotiating as a department with a problem. I have not been prepared to enter into any discussion about what the tax system will do, and our tax inspectors will make their judgments on the facts of the case, as they would with any other department.

Q186 Chairman: The fact is that they have made profits of, what is it over the last ten years out of the Inland Revenue, £2.5 billion, is that right? That is what the NAO brief tells me.

Mr Varney: Ish.

Q187 Chairman: £71 million sounds a lot when you compare it to £2.5 billion profit out of the Inland Revenue. I apologise, £2.5 billion revenue.

Mr Varney: What we have done is faced with the contract that we have got, we have tried to negotiate the best deal. We have had a hardnosed approach to going to court and we have taken from lawyers the best advice as to what we should settle for. We did that before we got into the end of the negotiations. We then got to a stage where we were getting beyond where the lawyers felt we should settle and we went for a settlement which was designed to deliver benefit for the taxpayer.

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Q188 Mr Bacon: Could I just clarify as to actual payments. I think you said a moment ago in open session that £44 million has been paid?

Mr Varney: Yes.

Q189 Mr Bacon: That is the 31 plus one staged payment. £71.25 million minus £44 million leaves £27 million. When are you expecting that to be paid?

Mr Varney: Over the next three years.

Q190 Mr Bacon: At which point?

Mr Varney: We think it will be paid each year.

Mr Hartnett: What will happen, Mr Bacon, is that EDS have to pay us 4.5% of revenues from government work on a quarterly basis until the sum is paid.

Q191 Mr Bacon: 4.5% of revenues from government work?

Mr Hartnett: Yes. New government work, sorry.

Q192 Mr Bacon: From new government work?

Mr Hartnett: Yes.

Q193 Mr Bacon: So that *** order book you were talking about is irrelevant?

Mr Hartnett: In what sense?

Mr Varney: It is well covered.

Q194 Mr Bacon: Covered in the sense of a dividend cover?

Mr Varney: Yes.

Q195 Mr Bacon: In terms of where the money comes from, none of that *** order book— By the way, was that *** order book UK government work, or is it just UK work?

Mr Hartnett: Almost entirely government work.

Q196 Mr Bacon: But none of it is applied to this settlement, it is all new business that they have not yet won that you are talking about. That is right, is it not?

Mr Hartnett: Yes, but let me just explain what we did. We looked back over the last four years of EDS converting its pipeline work into real contracts so we could establish trend. We looked at the profit margins that applied and on those calculations we then derived a figure from that which told us what we had to get on a quarterly basis with some cover to deliver the £26.6 million over three years.

Mr Varney: Can I just add, which I think we have not done justice to, if the money is not paid at the end of the three years, besides the fact that we have got the right to reopen the case, we have also built in a significant interest rate regime so that money that is outstanding at the end of the three years really attracts high interest rates which we hope will encourage them.

Q197 Mr Bacon: Can I just clarify that because I was busy writing it down. 4.5% of their revenue is from new government work paid on a quarterly basis until the £26 million is paid off. That is right, is it not?

Mr Hartnett: Yes.

Q198 Mr Bacon: The *** you are talking about, that is not pipeline, that is actual extant work that they have got, is it not?

Mr Hartnett: No. The *** is work in their pipeline that they hope to attract.

Q199 Mr Bacon: You called it their order book. There is a difference between an order book and you hope to bid for that. An order book is when you have got a contract.

Mr Hartnett: I think I called it their pipeline.

Q200 Mr Bacon: Originally you called it their order book.

Mr Hartnett: I apologise. That was why I explained to you—

Q201 Mr Bacon: What is their order book?

Mr Hartnett: We did an historic conversion.

Q202 Mr Bacon: What is their order book?

Mr Hartnett: Their actual order book?

Q203 Mr Bacon: What is the value of their present government—

Mr Hartnett: I cannot recall. We can look back at the notes.

Q204 Mr Bacon: It is a lot less than *** presumably?

Mr Hartnett: Yes, but this converts at a rate, from memory, of about 45%.

Q205 Mr Bacon: They get slightly less than half the work they bid for basically.

Mr Hartnett: Yes.

Q206 Mr Bacon: That is very helpful. Basically, every three months you are expecting to get a cash payment until the £26 million has been paid off.

Mr Varney: Yes.

Q207 Mr Bacon: Is it possible you can keep the Committee and the NAO updated as to how those payments are coming in?

Mr Varney: Yes.

Q208 Mr Bacon: That would be very helpful. The Chairman mentioned £2.5 billion sterling of business over the last ten years. Based on what you know about the margins which EDS has applied to its work, what is your estimate of the profit that EDS has made on that £2.5 billion of work over the last ten years?

Mr Hartnett: I do not think I can do ten years for you. I can do illustratively the last couple.

Q209 Mr Bacon: The NAO tells us that the Inland Revenue, not just government but EDS has had £2.5 billion of work with the Inland Revenue over the last ten years. You must have got a rough ballpark idea in your head of how much profit they made out of that.

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Mr Hartnett: If the last 15 months and 12 months before that are illustrative of the whole ten year period then something over 20% but short of 25%.

Q210 Mr Bacon: Something over 20% but?

Mr Hartnett: Short of 25%. I am trying to do the sum in my head.

Q211 Mr Bacon: So 20% would be £500 million profit over ten years?

Mr Hartnett: That might be a plausible figure.

Q212 Mr Bacon: What was the revenue and the profit figure, to take the 15 months that you are talking about?

Mr Jones: In the 15 months to 30 June 2004, EDS earned revenue of £504.6 million from the contract.

Q213 Mr Bacon: They made profits of £100 million.

Mr Jones: That gave rise to a profit of £121.3 million.

Q214 Mr Bacon: Just over the last 15 months?

Mr Jones: Just over the last 15 months, yes.

Q215 Mr Bacon: Despite Mr Varney's assurances about the fact that they are in a weak financial state, they could have written you a cheque for £71 million?

Mr Varney: The corporate results of EDS have had major problems. The issue is that we are talking about part of what they delivered, that is the area where you have got to look. You have got to look for the claim in the light of the contract which has been entered into. We could all fantasise about what we could recover on absolute figures but what we have actually got to do is look at what the contract says and what we can realistically expect from the court.

Q216 Mr Bacon: I have got one more question which is really to the Treasury. I am very unhappy about the idea of agreements being entered into that are confidential because it makes it very difficult for the public and the taxpayers to see what is going on. As I said earlier, you have issued guidance to departments about avoiding confidentiality clauses and severance payments for individuals—the Health Service is a particular example, notoriously so, despite guidance from your Department and from the Treasury—what is different about this? Why would you not be just as keen to issue guidance against confidentiality clauses and settlements of this nature with IT companies?

Ms Diggle: I see the point that you have, Mr Bacon. I think the key fact here is that it was a shrewd deal. Looking back at the report which the PAC issued only last week, you sought to ask all departments to be commercially astute and it seems to me that this is an instance of one department seeking to do precisely that.

Q217 Mr Bacon: You are also saying that value for money can only be achieved through secret deals, are you not?

Ms Diggle: I was not saying that. Sometimes there is a tension between two aims, and here there is a tension and this Department has sought to sort this out.

Mr Bacon: Thank you.

Q218 Mr Williams: When you put your heads together and worked out the maximum you originally thought you might be entitled to, what was the key figure you arrived at?

Mr Hartnett: Originally, Mr Williams, it was gross £209 million. That was made up of incorrect payments, staff costs, giros, cheques if you like, and fixes and re-engineerings to the NTC system. As David said, we have an obligation to mitigate our losses in any way we can and we plan to recover £105 million of the incorrect payments which left us suing, if we had gone to court, for a net amount of £104 million.

Q219 Mr Williams: So you felt you were owed £104 million and you got £71 million. Does that mean EDS established that you were at fault for the other £33 million?

Mr Varney: No. I think when you go into a court case like this you are putting the best case you can on what you think the court is going to state. The court is unlikely to award you more than you ask for, it is likely to award you less, so commonsense is you go in with the most defensible aggressive statement of your position. ***

Q220 Mr Williams: In a way we have been a bit unbalanced in our inquiry, have we not? We have focused completely on the faults of EDS and presumed there is no fault on your side at all. What did they quote against you as being your errors in leading to this situation?

Mr Varney: Our faults were legion.

Q221 Mr Williams: I am sorry, I cannot hear you.

Mr Varney: They are bound to argue that.

Q222 Mr Williams: But you also had to accept that some of them were valid otherwise you would not have dropped them.

Mr Varney: No.

Q223 Mr Williams: Would you let us have a list of their allegations of your failures?

Mr Hartnett: Mr Williams, two things may help—

Q224 Chairman: Is that a yes or no?

Mr Hartnett: Of course we will let you have a list but I need to explain that the list is going to be rather difficult to draw up. We had several offers of settlement from EDS: £5 million, £10 million and, I think, £17 million. One of the really difficult issues was that we were engaging all the time, until we got to the very serious negotiation on the quantum at the end, and they were pushing back, but not pushing back in detail. I think the principal accusation they made against us was that we were in partnership with them to deliver the system and partners should not be claiming damages from each other.

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Q225 Mr Williams: Was the compressed timetable for testing a factor in it? Whose decision was it to compress the timetable?

Mr Hartnett: The proposal to compress the timetable actually came from EDS to solve a problem. If I might, can I just read you the certificate that was given to us by EDS just before we went live? It said this: "I consider that this release of software is fit for purpose of supporting all current and agreed business and statutory requirements for live use in support of business requirement computer systems to help the Inland Revenue's obligation to provide new Tax Credits". They signed off the system as fit for purpose.

Q226 Mr Williams: At the end of the day, I am asking you, with hindsight, would it have been better if there had not been a compressed timetable? If it would have been better, who was it who compressed it?

Mr Hartnett: I think the answer to that, if I may, is one I think I have given the Committee before. I do not believe the compression itself caused the problem, I think the problem was caused by the wrong sort of testing.

Q227 Mr Williams: It may not have caused it but it may have identified it.

Mr Varney: The only time the arguments of EDS and ourselves have been put to the test is when there have been attempts at independent evaluation entered into. We came out of that with support for our case. That did not mean we were going to get £104 million. We were trying to conduct a commercial negotiation in which both sides were going to take positions from which they would have to negotiate a solution or the court would take a solution, and that was what we did. We came out with an answer which we thought was sufficiently reflective of improving the opportunities that would have been available in the court with the added advantage of certainty, nearness of time, and we were reinforced because we had this independent view by a judge of the relative merits of the two cases.

Q228 Mr Williams: Were any of the major causes of the situation such that they would have been identified if there had been a non-compressed timetable?

Mr Varney: I do not know, Mr Williams. I do not think so. Do I think we are without sin? Probably not. Did I enter this negotiation on the basis of, "There is the right answer, let us take something off the table because it is our fault"? No, I did not. I sought what was the best answer.

Q229 Mr Williams: You are talking about the negotiation; I am talking about the situation. Up until now we have been concentrating on EDS's failures that led to the situation, but I want to be sure that we also pay due attention to whether your Department, way back before your time, not at negotiation but in the preparation of the scheme and the assessment of the scheme, contributed to this situation by not having adequate processes.

Mr Varney: I am saying the area you are talking about Mr Hartnett answered. Can I just say that in the 159 days that Parliament has sat, since I took over responsibility for HM Revenue and Customs, I have appeared at eight Select Committee hearings and the vast majority of those committees have been talking about new Tax Credits. I have acknowledged at each one that the Department has fallen short of the standards expected by the people it serves, I have done that. In coming to this, I have tried to do a settlement which I think is in the public interest and which opens a new chapter in the relationship between the government and service providers.

Q230 Mr Khan: I have just a few very brief questions. During the course of your answers to the questions, it is quite clear there is an indirect criticism that you as lay people accepted the advice of your QC and your solicitors, and that seems clear. Can you just explain to us the processes you went through from offers and counter-offers being made before you reached the decision to accept your leading counsel's opinion and your solicitor's opinion to settle the case in the terms that you did?

Mr Varney: The early offers were quite easy to refuse because they were derisory. I had in mind a £31 million cap. I had in mind the advice of the judge in considering the case. That was at the back of my mind. Also in my mind was what was the appropriate level at which these negotiations were being conducted. Our strategy all the way through was to keep the negotiations at the working level because in the end this was going to be settled chairman to chairman. We needed to get the build-up. We tried the independent route, because I think it would have been irresponsible not to, and we were pleasantly surprised with what came out. At each stage we asked the lawyers for their view of what was a reasonable settlement. I will spare their blushes, they are expensive enough, but we have a very good quality legal team who are experienced in these matters and they came up with a view. I have spent most of life in commerce listening to legal advice and I have my own commercial feel of what I think we need to do. My sense was also thinking about the way the negotiations were going and talking to our ex-com about what we were prepared to settle for. What we did was we got EDS to the maximum point that we felt we could get them to on cash or near cash. They wanted us to have services; we were looking for taking money out of what they sell in the future. We then asked the lawyers to independently review the settlement and say whether they thought it represented value for money against the outcome in the court and they produced some analysis of what they thought we would get from the court, and all of that suggested that we weigh that, plus the time and the burden on an organisation that has already got a number of significant challenges on it, and we came to the conclusion this was in the best interests of the taxpayers.

Q231 Mr Khan: My final question, Chairman, and thank you very much for allowing me the indulgence, is this: we can see from your letter you

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have referred to the pleadings of what was alleged by them, and I think Mr Williams has referred to wanting to see the defence and what was accepted, but bearing in mind the criticism you would undoubtedly have got had you lost the case and spent more money on lawyers and all the rest of it, and bearing in mind I am sure they would have used some of the stuff you and the Committee have said in public about your failings, because you have been so open and candid, do you have any regrets about the way things have been handled so far as litigation is concerned? Would you have done things differently so far as the litigation and negotiations were concerned?

Mr Varney: No. These have been a tough set of negotiations. We looked around the public sector for whether there was any guide on settlements and we could not find a significant settlement in the public sector. We looked around in this particular area of practice because this is the biggest settlement that we know of. Could we have done it better? I think the honest answer is I would improve EDS's negotiating capability. We gave it the best try we could. All of this team has been involved, my Ex-com has been involved, Mr Hartnett led it, Paul Gray has been involved, and we tried at each level to make sure we were clearly pushing towards a solution and in the end it was going to be done at chairman to chairman level.

Q232 Mr Bacon: One question about the £105 million that you are expecting to get back from the claimants as part of the £209 million: how much of that do you think you will actually get back and to what extent is the amount of the £105 million that you will get back impacted by the Chancellor's announcement of the increase of the threshold to £25,000?

Mr Varney: We have made provision in the accounts on the basis that we will get 50% back. The issue for us in the settlement with EDS—I take you back to the EDS issue—is that if it increases the cost over £31 million we cannot use that to claim more money from EDS. There is a cap on an event which says if the thing cost two billion or five billion, you can only get £31 million.

Mr Jones: Can I just add to that, Mr Bacon? We looked at each element of loss and some elements had been written off in their entirety, some we were wholly trying to recover and some we were partly trying to recover. In relation to those elements we were wholly or partly trying to recover we made estimates based on the current experience of recovering those particular overpayments to arrive at the net loss to the Exchequer, and it is those net figures that make up the £104 million.

Q233 Mr Bacon: I am talking about the £105 million, in other words the element referred to in the NAO's brief to us. £104 million and £105 million make £209 million. I am talking about the £105 million that may be recovered from claimants. That is £105 million of overpayments, is it not, that you hope to recover? Is that correct?

Mr Varney: Yes.

Q234 Mr Bacon: What I was really asking you was simply this: are you saying that £105 million is a net figure after taking account of the Chancellor's announcement? The Chancellor's announcement basically increased—

Mr Varney: They are not linked.

Q235 Mr Bacon: They are not linked?

Mr Varney: No, because the Chancellor's announcement is going forward.

Q236 Mr Bacon: Not backwards? It is purely going forward.

Mr Varney: Mr Bacon, there is an issue, which we have faced, which is—

Q237 Mr Bacon: From April 2007, I am sorry, yes.

Mr Varney:—when is the right time to negotiate with EDS. We have assembled millions of bits of paper to illuminate our case. We are ready to go to court. If we hold it, we get a bit more information but then memories get a bit staler.

Q238 Mr Bacon: Going back to my original question, of the £105 million that you expect to recover from claimants, what amount of that do you actually think you will get?

Mr Varney: I think that is our best estimate at the moment.

Q239 Mr Bacon: That is your best shot.

Mr Varney: That is our best estimate.

Q240 Chairman: In conclusion, I just wonder whether, given the problems that the government has had with EDS, they should trigger enough business with government to ensure you get the full compensation and whether there will be quite the wrong incentive on the government to give them that business for that reason.

Mr Varney: I think the answer is as I said to Mr Williams in open session. First of all, EDS is a company of tremendous capabilities but this was clearly something which they did not do well. They have replaced their chief executive and chairman. The new chief executive is a seasoned and highly professional IT person turning round the company and, as far as I can see, he is having a success in doing that. He was a pleasure, in a sense, to do business with.

Q241 Chairman: Okay. I warn you that this Committee might well be critical of the fact that a third of this compensation does depend on EDS generating new business with government. I give you that warning that our Report might well say that because I personally believe it.

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Mr Varney: It is your decision what you put in your Report. You take your own advice, but can I say that if this Report⁸ is going to have an impact on

departments it has got to lift up examples of good practice on reaching commercial settlements. If you do not do that then I think this is just motherhood and apple pie, with respect.

Note by witness: Sir David Varney was referring here to the Committee's 17th Report (HC 742, Session 2005–06) *Achieving value for money in the delivery of public services.*

Chairman: That is a very robust answer. Thank you very much.

Supplementary memorandum submitted by HM Revenue and Customs

Question 47 (Mr Greg Clark): Increased Tax Credits disregard

This was part of a package of measures announced in the 2005 Pre-Budget Report. Overall, the package of measures is expected to have the following Exchequer effect: – £100 million in 2006–07, +£200 million in 2007–08 and +£50 million in 2008–09, as set down in table 1.2 of the 2006 Pre-Budget Report.

1. The Exchequer effect of the changes to the tax credit system depend crucially on the source of overpayments. The Paymaster General's statement to the House on 5 December 2005 noted a number of different sources of overpayments, of which income rises above the income disregard was only one. There is, however, only limited information available on the sources of overpayments. The only year for which HM Revenue and Customs have complete data is 2003–04, yet this year was not representative of how the system will operate in steady state for a number of reasons. One of those reasons is that the initial income information used in calculating awards was two years old rather than one year old as it is for all future years.

2. The first stage of the finalisation process for 2004–05 awards was only completed in September 2005, and the full finalisation process is not due to complete until January 2006. Therefore the information on the sources of overpayments in 2004–05, which is more representative of the ongoing position than 2003–04, is incomplete. Further, even when the information is assembled, it is often not obvious why tax credits claimants received an under or overpayment without a detailed analysis of the case.

3. The difficulty in accessing good quality data makes costing the individual elements of the package difficult. Moreover, there are uncertainties around the behavioural response to the measures and importantly significant interactions between the different elements of the package. For example, the effect of limiting the size of in year adjustments to tax credit payments (due to begin in November 2006) is affected by the increased size of the disregard as this affects whether adjustments would need to be made in the first place.

4. While the overall cost of the package is not affected by the order with which the changes are modelled, these interactions mean that the costs of the individual elements of the package are affected by the assumed order. It therefore makes it very difficult to produce an accurate desegregation of the overall cost.

5. Taking these factors together, while the overall Exchequer effect of these reforms as a whole can be modelled with greater certainty, it is not possible to produce reliable estimates of the cost of the individual elements on their own.

6. As Mr Gray indicated at the hearing, it would not be right to assume that the Exchequer cost of the increased disregard was the £2.2 billion of overpayments seen in 2003–04. As noted above, the Paymaster General's statement made clear that there were a number of important factors contributing to overpayments. In addition, the statement also notes that, while in the absence of any action overpayments would continue at broadly the levels seen in 2003–04, the package of measures will, once fully implemented, reduce the level of overpayments by around one-third.

Question 140 (Mr Alan Williams): Number and size of Tax Credits overpayments reclaimed

HMRC produces information on overpayments by using a sample of data. For 2003–04 the statistics were based on a 10% sample. The results were published in "Child and Working Tax Credits Statistics. Finalised awards 2003–04. Supplement on payments in 2003–04."

The published results show that 40,000 2003–04 awards were overpaid by £5,000 or more at 5 April 2004. The Paymaster General provided further details in a Parliamentary Question answered on the 10 October 2005; see table below. We estimate that for 1,000 of these awards the overpayment was £10,000 or more, but this is subject to significant sampling uncertainty. The available data does not permit a reliable finer breakdown of the number of overpayments above £10,000.

Finalised 2003–04 awards underpaid or overpaid at 5 April 2004, by size of under or overpayment

<i>Size of underpayment or overpayment</i>	<i>Underpaid award (thousands)</i>	<i>Overpaid awards (thousands)</i>
Greater or equal to £5,000 but less than £6,000	3	22
Greater or equal to £6,000 but less than £7,000	1	11
Greater or equal to £7,000 but less than £8,000	–	4
Greater or equal to £8,000 but less than £9,000	–	2
Greater or equal to £9,000 but less than £10,000	–	1
Greater or equal to £10,000	–	1

Notes

These figures are estimates based on a sample of all awards, therefore due to sampling uncertainty all figures below 0.5 thousand have been withheld.

The level of under or overpayment at 5 April 2004 for each award is based on the 2003–04 entitlement calculated from the family's circumstances and income in 2003–04 reported by April 2005.

Question 148 (Mr Alan Williams): Number and value of tax overpayments identified in PAYE review

As Mr Varney said in response to Mr Williams's questions, HMRC Internal Audit reviewed a range of PAYE business activities. The overall position disclosed by these reviews was an estimate that some £295 million was likely to have been overpaid by 2.5 million customers. But although the reviews indicate the potential scale of the problem, they are based on a statistical sample and do not provide a mechanism for identifying the individual cases affected.

Of these reviews, the one with the main financial consequences concerned taxpayers with more than one concurrent employment at the end of the year in question. For this group, Internal Audit used a sample of 545 records out of a population of approximately 3.9 million taxpayers. The review indicated that 1.1 million customers may have overpaid around £276 million. Disaggregating this sample inevitably means wider margins of error but these results suggest that:

- 25% of the sample had overpaid between £10 and £50
- 32% of the sample had overpaid between £50 and £200
- 33% of the sample had overpaid between £200 and £600 and
- 10% of the sample had overpaid a higher amount.

Since at the time of the sampling exercise our end-of-year clearance work had not concluded, it is possible that some overpayment (and underpayment) errors were subsequently identified and corrected. It is not possible to quantify how many and given the nature of the errors identified in the sample tested, we suspect that many would have slipped through our end-of-year processes undetected.

It is important to note that the exercise was conducted and designed to test how well our PAYE processes handled records of customers who have more than one concurrent employment in a year so that, if necessary, improvements to those processes could be identified and implemented. The exercise was not designed to enable us to identify and correct all the potential over/underpayments which the sample implied are likely to have occurred. To attempt to identify all the specific cases in that year where material over/underpayments had occurred, and to bring such cases to a conclusion, would be prohibitively expensive and could only be done by diverting substantial staff numbers from other areas of the Department's work and accepting a build-up of backlogs in current work. We have therefore concluded that it would be better for our customers and better value for money for us to concentrate our resources on improving our PAYE processes to reduce errors and over/underpayments in current and future tax years.

Supplementary memorandum submitted by Paula Diggle, Treasury Officer of Accounts

Question 130 (Mr Richard Bacon): Confidentiality in public sector settlements

Mr Bacon asked whether the Treasury had issued guidance on confidentiality clauses similar to the existing guidance on settlements paid to individual employees in the public service.

2. As I thought at the time, the short answer is no. It may be helpful if I explain.

3. The long standing existing guidance on staff severance payments was most recently restated in August 2005. The basic rule is that such payments should normally be within the contractual terms and conditions of the post, and that any departure from this approach should be exceptional. The guidance goes on to

advise that that any undertakings about confidentiality in special severance settlements should leave the transactions concerned open to adequate public scrutiny, including by the NAO and PAC.

4. The guidance leaves open scope for a measure of confidentiality—albeit exceptionally—because there could be cases where the Accounting Officer concerned might judge it to be in the public interest. Any such judgement would have to take account of all the other relevant factors, which might include value for money, the scope for repercussions elsewhere in the public service, and so on. Generally the Treasury is reluctant to support confidential settlements because they can encourage public service employers to pay well above the odds. Thus they tend to offer poor value for money.

5. In the case of HMRC's settlement with EDS, similar principles apply. It was for David Varney as Accounting Officer to take a judgement, on the facts of the case, about the best outcome for his department and the public service generally. As he explained to the Committee, the factors he brought in to the balance included the scale and quality of the financial outcome, the cost of continuing with the court case, the avoidance of diversion of senior management time, and the certainty to be achieved. It was entirely proper for him to weigh these features of the potential deal; and he took legal advice about the prognosis of the legal action had it continued. As he explained to the committee, he assessed that appreciably better value for money could be delivered with a confidentiality clause similar to that common in commercial contractual settlements—of which he cited some relevant experience.

6. The judgment he took differs from that in a severance case in at least one important respect. Unlike a severance settlement, the scope for repercussions from HMRC's deal was not a significant risk to be considered because the exact circumstances of a similar high profile contractual case are unlikely to recur. Such disputes are rare; whereas severance settlements are relatively common, and occur in a wide variety of different public bodies, which could be affected by precedents elsewhere.

7. Moreover, HMRC has in no way avoided proper public scrutiny. As the witnesses explained, NAO has been privy to the details of the settlement with the contractor. An appropriate, audited, disclosure will be included in HMRC's resource accounts for 2005–06. In addition, the Committee had a full opportunity to hold HMRC to account in the private session of the hearing on 14 December, when the witnesses explained their approach in some depth.
