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REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

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HM Revenue & Customs

Progress on reducing costs

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National Audit Office

HM Revenue & Customs

Progress on reducing costs

Report by the Comptroller and Auditor General

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Comptroller and Auditor General
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This report assesses HMRC's progress in making cost reductions in 2011-12 and its readiness to deliver future savings.

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Contents

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This report can be found on the National Audit Office website at www.nao.org.uk/HMRC-costs-2013

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Key facts

5%	£296m	£585m
reduction in HMRC's running costs between 2010-11 and 2011-12	cost savings made in 2011-12	remaining savings to be made by 2014-15

25 per cent	gross savings to be achieved over the four years to 2014-15
15 per cent	net cost reduction over four years to 2014-15 after reinvesting £917 million to increase tax revenues
2,400	reduction in average full-time equivalent staff during 2011-12: HMRC plans to reduce overall staff by 10,000 full-time equivalents by 2014-15
138,000m^2	reduction in HMRC's estate in 2011-12: it plans to reduce its estate by 300,000 square metres by 2014-15

Summary

1 Reducing the deficit is a government priority. The 2010 spending review announced significant spending reductions across government departments. The government recognised that HM Revenue & Customs (HMRC) could contribute to reducing the deficit both by reducing its costs and by increasing tax revenues.

2 As the UK's main tax administrator, HMRC collected £474.2 billion of tax in 2011-12 and paid out £42.7 billion in benefits and credits. Its running cost in 2011-12 was £3.7 billion. To address the government's objective of cost reduction, HMRC's 2010 spending review settlement requires it to:

- reduce its annual running costs by 25 per cent (£955 million) by 2014-15; and
- bring in an additional £7 billion a year of tax revenues by 2014-15 by reinvesting 40 per cent of its savings to tackle evasion and avoidance.

3 The main ways in which HMRC plans to make its sustainable savings by 2014-15 are through:

- reducing staff numbers by 10,000;
- reducing its estate by 300,000m^2;
- reducing the cost of its IT by £88 million; and
- increasing staff productivity.

4 HMRC faces significant challenges to achieve its strategic priorities of reducing costs, increasing tax revenues and improving, or at least maintaining, customer service. Its 2010 spending review settlement also includes targets to:

- reduce expenditure on benefits and credits by £8.3 billion by 2014-15;
- hand over administration of tax credits to the Department for Work and Pensions by 2017; and
- introduce a major technology change called 'real time information' (RTI), which will require employers to report their employees' income tax and national insurance deductions as they pay them rather than at year-end.

5 This report covers only HMRC's progress in reducing its running costs. We will report separately on HMRC's progress in reducing tax credit error and fraud, introducing RTI and increasing tax revenues in 2013. We reported on HMRC's customer service in December 2012.

6 This is one of a number of reports on cost reduction across government and our second on HMRC's cost reduction programme. In July 2011 we reported that HMRC had a clear vision for 2015 and had put in place many of the necessary arrangements to reduce costs. However, to achieve value for money it needed to better understand costs and value, the interdependencies between its projects, and the projects critical to achieving the programme. This report assesses HMRC's progress over the last 18 months, its performance in reducing its costs in 2011-12 and its readiness to deliver future savings.

Key findings

Long-term strategy

7 HMRC's cost reduction and reinvestment plans are aligned with the options HMRC is considering for transforming its business in the longer term. In our last report and our report on HMRC's 2011-12 accounts, we criticised HMRC's lack of an organisation-wide operational strategy. Though it has yet to decide, HMRC is actively considering options for how it could operate in the future, such as further reducing its budget or broadening its role. Reducing staff time required to help those who pay their tax voluntarily and shifting resources into more enforcement and compliance work is consistent with HMRC's long-term vision for efficient and effective tax administration (paragraphs 3.3 and 3.4).

Performance in 2011-12

8 In challenging circumstances, HMRC made £296 million of savings in 2011-12, exceeding its target by 19 per cent. This is about one-third of the total saving it is required to make over the four years of the spending review period (paragraphs 2.2 and 2.9 to 2.24). It achieved savings in five main areas:

- It reduced staff numbers by 2,400 full-time equivalents and improved staff productivity, saving £140 million.
- The government froze pay increases for which HMRC had budgeted in 2011-12, saving £29 million.
- HMRC reduced the price it paid for IT equipment, such as laptops, and services, such as IT support helplines, by £74 million.
- HMRC vacated 118 buildings fully and 28 partially, reducing the size of its estate by 138,000 square metres and resulting in savings of £26.8 million.
- It reduced the cost of other contracts, such as those for postage and printing, by, for example, reducing the amount of unnecessary information HMRC sends to customers, saving around £26 million.

9 HMRC maintained its performance in key strategic areas while reducing staff and spending. HMRC exceeded its overall 2011-12 target for collecting additional tax revenues, maintained tax collection and reduced the level of tax debt. It restored customer service performance from a low point in 2010-11 but did not meet all of its customer service targets. This was not because of cost reduction but because of problems, from which HMRC is still recovering, in introducing its new National Insurance and PAYE system (NPS) in 2009-10, on which we have previously reported (paragraphs 2.5 to 2.8).

10 HMRC cannot link a quarter of its 2011-12 savings to specific process improvements. In 2011-12, HMRC has improved its efficiency by, for example, making processes consistent across offices, removing duplication, and producing and acting on better management information. This released staff time from work judged to be low value, unnecessary or unproductive. Its business areas have successfully lived within reduced budgets but HMRC does not collect the information it would need on staff time to be able to link savings to actual changes in processes. HMRC risks making changes which add little or no value if it cannot link these savings with the changes made. It estimates it has saved £72 million from process improvements but its estimate is simply the balance of savings made once it has taken other quantifiable productivity improvements, mainly relating to reducing sickness absence, into account (paragraphs 2.12 to 2.14).

11 HMRC's accounts show that running costs reduced by £204 million (5 per cent), after inflation, between 2010-11 and 2011-12. This is what we would expect to see taking into account all savings, reinvestment and additional funding agreed with HM Treasury for specific activities. It is important for HMRC to reconcile cost reductions to movements in the annual accounts to demonstrate that savings result in reduced expenditure and are not offset by cost growth elsewhere in the business (paragraphs 2.2 to 2.3, 2.18 and 2.24).

Managing the change programme

12 HMRC is spending £376 million in total on change projects across the four years of the spending review period to make sustainable savings of £411 million a year by 2014-15. Sustainable savings are those that lead to a permanent reduction in the baseline cost of an activity (paragraph 1.14).

13 HMRC expects change projects to save £162 million less over the spending review period than when we last reported in July 2011. This is partly because its forecasts are more refined and realistic, and partly because, as some projects took longer to start, HMRC expects them to take longer to start realising benefits. In 2011-12, of the £136 million HMRC could invest in cost reduction projects, it spent £102 million. The result is that HMRC may have to forego some of the expected savings. Following its experience in 2011-12, HMRC more closely scrutinises the progress of change projects, both individually and as a portfolio (paragraphs 3.6 and 3.23 to 3.24).

14 HMRC has strengthened how it manages its change programme in ways that address our recommendations and those of the Committee of Public Accounts on governance and contingency arrangements. We recommended that HMRC ensure its governance arrangements were working effectively to provide early sight of under-delivery, and that it identify contingency arrangements, which it has done. HMRC has improved how it manages its projects as a portfolio by more regularly reprioritising, accelerating or cancelling projects according to need. It has also identified a pool of additional projects which it is not actively pursuing but it could draw upon. However, it has already committed 77 per cent of its change programme spending, limiting its flexibility to reprioritise projects (paragraphs 3.18 to 3.24).

15 However, HMRC has some way to go to address those recommendations related to its understanding of interdependencies and of the cost and value of its activities. HMRC has identified the key projects which enable cost reduction activities and it has identified and apportioned costs to its key, organisation-wide processes. However, it is not yet ready to act on this analysis by identifying further opportunities for cost reduction or performance improvement. While HMRC continues to strengthen its analysis, its understanding in these areas remains immature, considering that HMRC is almost halfway through the spending review period (paragraphs 3.25 to 3.26).

16 HMRC is now managing the change programme robustly. HMRC's change programme oversees its cost reduction and reinvestment plans. We agree with findings from the Major Projects Authority review of the change programme, which found that the programme's management arrangements and committee structure were comprehensive and proportionate to its scale and complexity (paragraph 1.17).

Continuing to make cost reductions

17 HMRC needs to make new savings of £585 million a year by 2014-15 and maintain those savings already made. At September 2012, HMRC was on track to exceed its 2012-13 cost reduction target by £29 million (paragraph 3.5).

18 Because HMRC expects change projects to make fewer savings than originally planned, £66 million more savings than planned will need to come from other initiatives such as productivity improvements or renegotiating its IT contract. HMRC expects business areas to make efficiency savings of £448 million by 2014-15. At July 2012, business areas had not yet fully worked out how they would make such savings in 2013-14 or beyond. Neither did they know how the savings may affect customer service performance (paragraphs 2.5 and 3.7 to 3.8).

19 Risks to reducing costs remain, mainly due to the complex interdependencies between projects (paragraphs 3.9 to 3.17). For example:

- HMRC has projects that aim to reduce the number of staff required to administer personal taxes by 8,500. This is intended both to reduce costs as some staff leave HMRC and to release staff who can be retrained to undertake enforcement and compliance activities. However, HMRC is uncertain about the impact of introducing RTI and universal credit on customer contact, which may impact on its ability to reduce staff in this area. In 2011-12 it did not move as many staff as planned into enforcement and compliance and therefore did not meet its target for reinvestment-funded work. It redeployed these staff into customer contact. It also employed more temporary staff.

- HMRC plans to reduce its estate by 300,000m^2, reducing its costs by £88 million by 2014-15. This will depend on HMRC reducing staff numbers as forecast and being ready to vacate buildings.

20 It is too early to tell what the long-term impact of cost reduction will be on performance. HMRC has maintained performance in 2011-12 while reducing costs. However, it is challenging for it to make more and deeper reductions over the spending review period and maintain performance, particularly customer service. HMRC's performance is not starting from a stable position. It is still recovering from introducing NPS and in the next two years has to introduce RTI and manage changes to benefits and credits. We and the Committee of Public Accounts recommended that HMRC model the impact of cost reduction on tax revenues and customer service over the spending review period. It is modelling the impact on tax revenues and has just started work to assess the impact on customer service (paragraph 2.5).

21 HMRC is improving the rigour of its approach to costing. When we last reported, HMRC had started work to cost its end-to-end processes. It has now calculated the costs of 23 common processes and is using this information to identify and prioritise areas where it can redesign or streamline processes. This work is still at an early stage and HMRC does not expect to make any savings from it before 2013-14 (paragraph 3.27).

Conclusion on value for money

22 HMRC faces a challenge to reduce costs over the spending review period while increasing tax revenues, improving customer service and introducing RTI and changes to benefits and credits. It has made good progress in creating the conditions to make cost reductions, putting in place and using strong governance arrangements. HMRC is moving from making tactical efficiency savings and quick wins towards a more strategic approach to managing and using its resources. Its cost reduction plans for the spending review period are consistent with its longer-term vision for transforming its business. HMRC exceeded its savings target for 2011-12 by 19 per cent, although it did not reconcile its savings to its accounts as part of its year-end processes. It is on track to meet its target again in 2012-13. It has maintained performance across key areas. We therefore conclude that it improved its cost-effectiveness and value for money in 2011-12.

23 HMRC has much work to do to meet its spending review targets by 2014-15 without impairing its performance. Its understanding of costs and the value of activities across the organisation is not yet sophisticated. This potentially undermines HMRC's ability to identify and implement sustainable cost savings. It has ongoing work in this area. HMRC will need to address these areas to deliver value for money in the future.

Recommendations

a **HMRC has made reasonable progress against NAO and PAC recommendations from our previous cost reduction report, but it should continue to implement and fully embed them.**

b **HMRC should continue to strengthen its management and governance of efficiency savings that are not related to defined projects.** In particular, it should continue to:

- require all business areas to submit more detailed plans explaining how they intend to live within reduced budgets for the rest of the spending review period and how they will monitor how they are making savings and fully test the assumptions underlying them;
- ensure all directorates are able to link costs and the value of their activities to enable them to identify realistic savings;
- track how areas are achieving savings in-year;
- link more closely cost reductions and performance at an operational level; and
- improve its understanding of costs and savings in the enforcement and compliance business area.

c **HMRC should reconcile the savings it claims back to changes in its administrative spending as reported in its annual accounts.** We made a similar recommendation in relation to the savings that HMRC was seeking to make from the 2007 spending review. HMRC has yet to build such a reconciliation into its year-end reporting process. Reconciling back will allow it to demonstrate that savings actually result in reduced expenditure and are not offset by cost growth in other parts of its business.

Part One

HMRC's plans to reduce costs

1.1 This part explains:

- the terms of HMRC's spending settlement; and
- how HMRC manages its change programme.

HMRC's spending settlement

HMRC's cost reductions are part of a wider change programme

1.2 HM Revenue & Customs (HMRC) is the UK's main tax administrator and also supports families and individuals through the benefits and credits it administers. In 2011-12 it collected £474.2 billion of tax and paid £42.6 billion in benefits and credits. Its annual running cost was £3.7 billion.

1.3 HMRC has a major programme of cost reductions which it plans to achieve through reducing staff numbers and IT costs, introducing new ways of working, increasing staff productivity and reducing its estate. Its cost reduction plans form part of a challenging change programme that is also designed to increase tax revenues and improve, or at least maintain, customer service. At the same time, HMRC must make significant changes to the PAYE system through the planned introduction of 'real-time information'[1] (RTI) – also required to enable the Department for Work and Pensions to introduce universal credit.

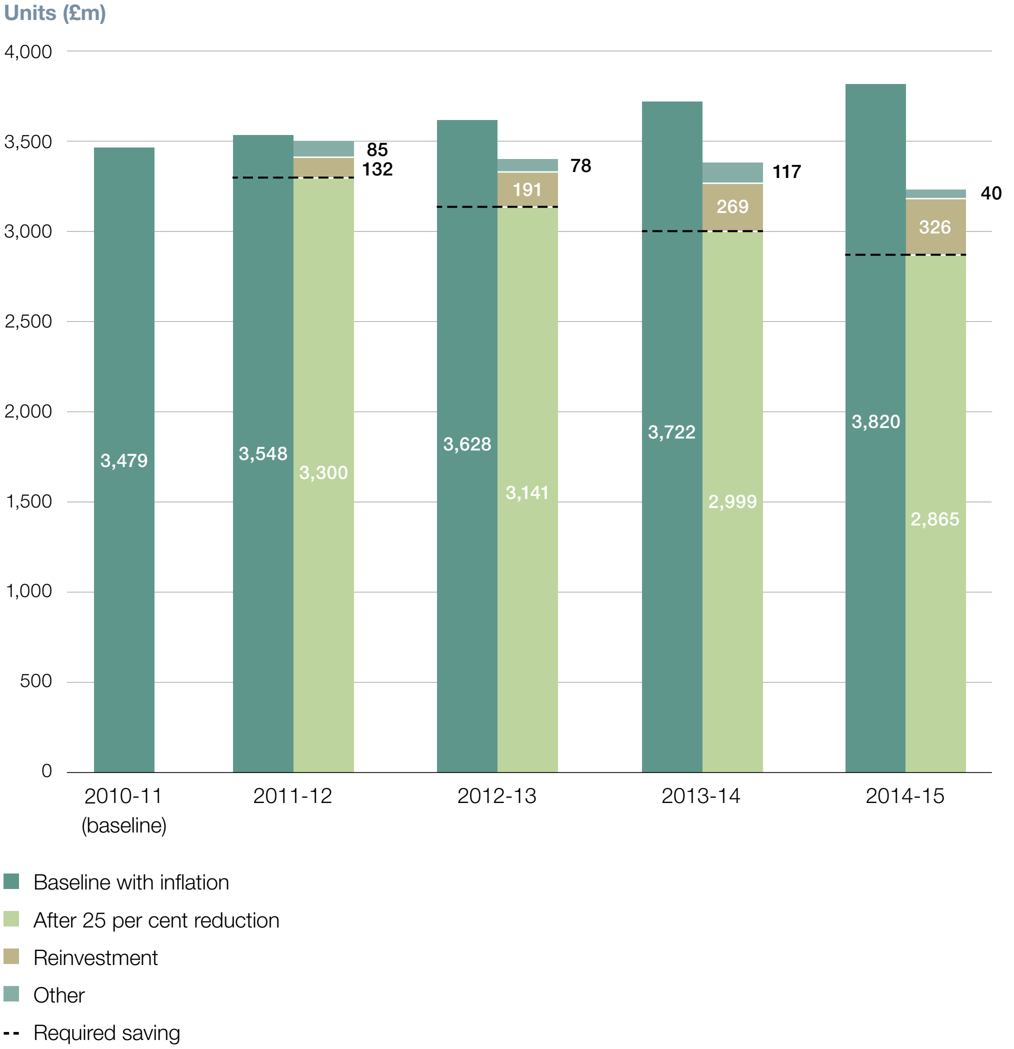
1.4 HMRC's spending review settlement requires it to reduce its running costs by 25 per cent, excluding depreciation but allowing for inflation, by 2014-15. This is a cost reduction of £955 million by 2014-15 (**Figure 1**). In negotiating the settlement, HM Treasury recognised how HMRC could contribute to reducing the budget deficit in two ways: by reducing its costs and increasing tax revenues. As a result, the settlement allowed HMRC to reinvest £917 million of savings to raise extra revenue of £7 billion a year by 2014-15 through additional work tackling evasion and avoidance. HMRC's revenue target for all enforcement and compliance work in 2014-15 would therefore be £20 billion.

1 Under RTI employers must report employees' income tax and National Insurance deductions to HMRC as they pay them rather than at year-end.

1.5 In addition to the £917 million of reinvestment funding mentioned above, HMRC has also been given additional funding from HM Treasury for redundancy payments and introducing RTI and changes to child benefit payments. Taking this into account, the net reduction in HMRC's running costs is 15.4 per cent by 2014-15.

Figure 1
HMRC's spending review settlement

The settlement requires HMRC to reduce its costs by £955 million a year by March 2015



NOTES

1 The baseline with inflation in each year shows how HMRC's resource departmental expenditure limit would have increased if there had been no spending review settlement.

2 The stacked bar for each year shows the total amount HMRC is allowed to spend.

3 Other additions include amounts to cover RTI, redundancy payments and changes to child benefit.

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

1.6 The spending settlement also included targets to reduce expenditure on tax credits, child benefit and other welfare entitlements. This report only focuses on HMRC's progress on reducing its running costs. We will report separately on HMRC's progress reducing tax credit error and fraud, introducing RTI and progress on increasing tax revenues in 2013. Other reductions in tax credit and child benefit are not within HMRC's control and therefore we have not examined them in this report. We reported on HMRC's customer service in December 2012.[2]

1.7 HM Treasury calculated HMRC's settlement by taking its 2010-11 resource departmental expenditure limit[3] and inflating it each year using GDP deflators to get to what HMRC's running costs would have been in 2014-15 if nothing had changed. After excluding depreciation, it then applied a 25 per cent reduction to the new inflated baseline (£3,820 million in Figure 1) equating to £955 million. It has split the amount it needs to save over the period to get to its in-year cost reduction targets. Cumulatively, HMRC expects to make in-year savings totalling £2.4 billion between April 2011 and March 2015 (Figure 11, page 30).

1.8 HMRC assesses its savings against the criteria below to determine whether they count towards its cost reduction target. Savings:

- are new and were not already reflected in its 2010-11 baseline;
- are realised within the year in which they are claimed;
- lead to a sustainable reduction in the cost of an activity, which must continue in future years and does not result in costs being reallocated elsewhere in government;
- release cash, either to reduce total expenditure or to enable cash to be spent on improving HMRC's performance; and
- do not adversely impact on performance or on HMRC achieving its strategic priorities.

Other tax authorities are also trying to reduce costs

1.9 HMRC's position is not unique. Other tax authorities are also trying to reduce costs. The Organisation for Economic Co-operation and Development's (OECD) 2012 report on tax administration[4] found that many tax authorities were trying to reduce costs. We examined the tax authorities of Denmark, the Netherlands and New Zealand because they had the most comparable cost reduction targets to HMRC. We found that they were all doing broadly the same things as HMRC to reduce costs (**Figure 2**).

2 Comptroller and Auditor General, *HMRC: Customer Service Performance*, Session 2012-13, HC 795, National Audit Office, December 2012.

3 Departmental expenditure limits are the budgets HM Treasury sets for general running costs. They are split into resource departmental expenditure limits covering spend on pay or procurement in back office and frontline activities and capital departmental expenditure limits relating to investment in assets such as buildings. HMRC's spending review settlement savings target only covered resource spending. Please see Part One of our report *Managing budgeting in government*, HC 597, Session 2012-13, 18 October 2012 for more details of how budgeting works in government.

4 Organisation for Economic Co-operation and Development, *Working smarter in structuring the administration, in compliance, and through legislation*, January 2012.

Figure 2
Other tax authorities are also trying to reduce costs

Other tax authorities are doing broadly the same things as HMRC to reduce costs

Tax administration	Danish Tax and Customs Administration	Dutch Tax and Customs Administration	New Zealand Inland Revenue Department	UK HM Revenue & Customs
Targets	Reduce budget by 25 per cent between 2004 and 2015 and reduce staff numbers by 17 per cent between 2011 and 2015.	Reduce budget by 15 per cent between 2011 and 2015.	Reduce budget by 7 per cent between 2012 and 2015.	Reduce budget by 25 per cent between 2010-11 and 2014-15.
Plans to reduce costs				
Reduce staff	✔	✔	✔	✔
Streamline processes	✔	✔		✔
Reduce estate		✔	✔	✔
Increase customer self-service and move customers to more cost-effective communication channels			✔	✔
Increase compliance		✔		✔
Working with others, for example external service providers			✔	
Simplify tax legislation		✔		
Reported progress so far	Reduced staff numbers by 4 per cent between 2009 and 2011.	Savings of €118 million in 2011, 4 per cent of budget. Most of savings made by streamlining tax processing. Staff numbers reduced by 948 to 29,010.	Savings of NZ$33.9 million (5 per cent) made in 2010-11 and reduced staff by 12 per cent (737) between June 2009 and June 2012.	Savings of £296 million in 2011-12 (8 per cent), including reduction of 2,376[1] full-time equivalents (3.6 per cent).

NOTE
1 HMRC's annual accounts show a reduction of 3,073 full-time equivalent staff members. This is based on average staff numbers across the course of the year; 2,376 represents the actual number of full-time equivalents leaving within the year.

Source: National Audit Office analysis of publicly available information on each authority, including annual reports and business plans

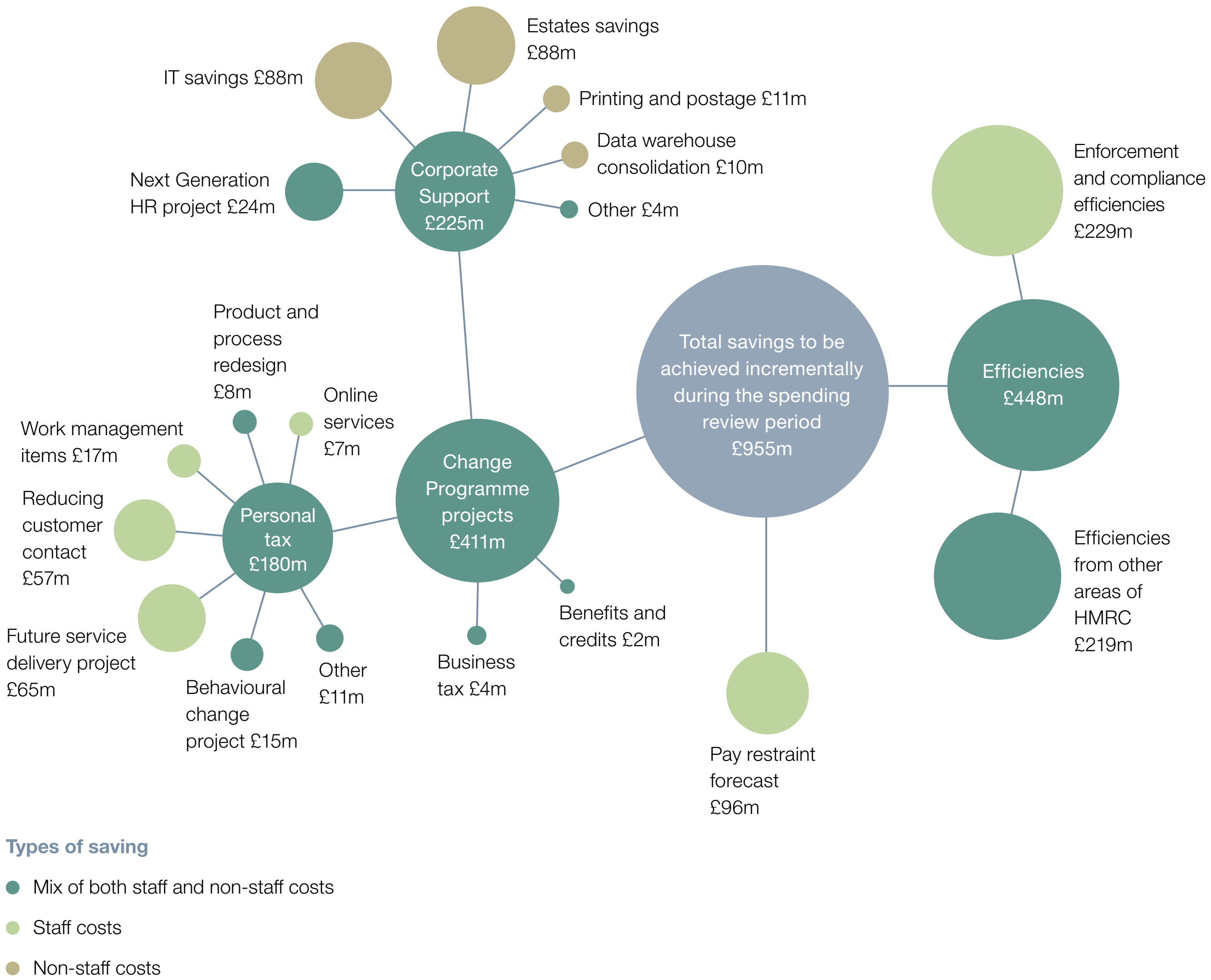
How HMRC plans to reduce its costs

1.10 Figure 3 shows how HMRC plans to make savings through change projects and improving efficiency.

Figure 3

HMRC's plans to reduce costs by £955 million by 2014-15

HMRC plans to save £411 million from change projects, £448 million from efficiencies and a further £96 million through the government's salary freeze



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

1.11 HMRC's spending review plans include moving 20,000 full-time equivalent staff (**Figure 4**). Some 10,000 will leave HMRC as it reduces its permanent headcount from 67,500 in 2010-11. Around ten thousand full-time equivalents will move within HMRC into enforcement and compliance activities as part of its £917 million reinvestment agreement. By 2015 more than half of HMRC's operational staff will be engaged in more complex compliance and enforcement work, representing 5 per cent of its revenue, with the remaining 95 per cent of tax being collected by substantially fewer staff. This is consistent with HMRC's vision for how it wants its business to develop, where the majority of tax is determined and paid online, and back-office systems are more automated, meaning that more resource can be devoted to closing the tax gap.

HMRC's change programme

1.12 HMRC manages its cost reduction programme within a central change programme. The change programme was set up to deliver the objectives of the spending review settlement outlined in paragraphs 1.3 to 1.6.

Figure 4
HMRC plans to reduce staff numbers and redeploy existing staff

More than 20,000 full-time equivalent staff will either leave HMRC or be redeployed

Full-time equivalent staff moves	2011-12	2012-13 (forecast)	2013-14 (forecast)	2014-15 (forecast)	Total
Leaving HMRC	2,376	2,800	3,100	2,110	10,386
External recruitment	-280	-550	-50	-40	-920
Moving from other parts of HMRC into the enforcement and compliance area	1,134	1,600	1,300	170	4,204
Moving within the enforcement and compliance area into reinvestment-funded work	2,728	2,410	1,000	340	6,478
Total staff reduction and redeployment	5,958	6,260	5,350	2,580	20,148

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

1.13 The change programme monitors both specific change projects and efficiency savings made by individual business areas. HMRC has nine individual business areas, including those administering and collecting taxes and back-office functions. Appendix Three shows how HMRC is organised.

1.14 Change projects are specific projects aimed at changing the way HMRC operates, while meeting the targets of the spending review settlement. For example, the 'future service delivery' project aims to save money by changing the way HMRC deals with customers. HMRC plans to invest £11.5 million in the project to save £64.9 million a year by 2014-15. The investment committee approves projects and the change delivery committee, which governs the change programme, monitors projects and is supported by a central team. Over the spending review period, HMRC expects to spend £376 million in total to deliver change projects forecast to reduce costs by £765 million in total by 2014-15, £411 million a year of which lead to a permanent reduction in costs and are therefore sustainable.

1.15 The change programme monitors all savings made by individual business areas. As well as reducing costs through defined projects, business areas expect to make savings by changing working processes to reduce costs, reducing sickness absence and by either no longer doing certain low-value activities or doing them at a reduced cost.

Previous Committee of Public Accounts and National Audit Office recommendations

1.16 In 2011, the Committee of Public Accounts and the NAO reported on HMRC's cost reduction plans for the spending review period to 2014-15.[5] Both reports were concerned that HMRC lacked contingency plans and that it needed to better understand cost and value, interdependencies between projects and how cost reductions could affect its ability to collect taxes. We set out progress against our recommendations in **Figure 5**.

1.17 Overall, since we last reported, HMRC has strengthened elements of the change programme. It is focusing more on understanding the interdependencies between projects, though this is still at an early stage, and risk management is more sophisticated and targeted. HMRC considers all the projects together as a group rather than looking at each in isolation. We concur with the Major Projects Authority's view that the governance arrangements are strong, with robust reporting and monitoring arrangements in place. However, HMRC has some way to go to address concerns around understanding the impact of cost reductions elsewhere in HMRC, managing interdependencies and assessing the link between the cost and value of activities.

5 HC Committee of Public Accounts, *HM Revenue & Customs: PAYE, tax credit debt and cost reduction*, Fifty-eighth Report of Session 2010–2012, HC 1565, December 2011; and the Comptroller and Auditor General's report *Reducing costs in HM Revenue & Customs*, Session 2010–2012, HC 1278, National Audit Office, July 2011.

Figure 5
Progress against Committee of Public Accounts and National Audit Office recommendations

HMRC has made progress against recommendations

Committee of Public Accounts recommendations	Progress
HMRC must extend its modelling to cover the risks and potential consequences of cost reductions on customer service and taxpayer compliance.	HMRC has modelled the impact of cost reduction on taxpayer compliance and has just started work on the impact on customer service (paragraph 2.5).
HMRC must demonstrate the credibility of its cost reduction programme by testing the realism of its plans, including their sensitivity to changes in the assumptions made, and ensuring adequate contingency is built in (also National Audit Office recommendation).	HMRC's approach of managing its projects as a portfolio addresses the Committee's concern about contingency. However, it needs to manage the portfolio robustly, as there is only limited flexibility within the change projects (paragraphs 3.19 to 3.24).
HMRC must ensure its project management arrangements provide clear evidence on the progress of all projects against the critical path for delivery and ensure that staff are held accountable for delivery (also National Audit Office recommendation).	HMRC has a high-level view of interdependencies, particularly for those projects that are key enablers for other projects, but recognises its understanding is still at an early stage (paragraphs 3.25 to 3.26).
NAO recommendations	
HMRC should extend its performance framework to define expectations to the end of the spending review period, linking potential for reducing costs or increasing revenue, or both, from a positive shift in customer compliance and improving business performance.	HMRC has targets across the spending review period for its key indicators. Its work to strengthen its understanding of the link between cost reduction, customer experience, revenues and compliance is at an early stage.
Business areas should define models of how they will operate.	Business areas produce three-year business plans, which include change projects and planned cost reductions.
Assess the link between cost and value of activities and draw on work to improve the quality of cost data to assess the potential for further cost reductions.	HMRC has work in place to understand costs and values, but it is not mature enough to have generated savings yet (paragraph 3.27). It remains difficult for HMRC to directly attribute sustainable cost reductions to activities such as Pacesetter (paragraphs 2.12 to 2.14).

Source: National Audit Office

Part Two

Cost reduction performance in 2011-12

2.1 HMRC exceeded its cost reduction target in 2011-12. This part of the report assesses:

- HMRC's achievements against its cost reduction target in 2011-12; and
- how and where HMRC made its savings.

HMRC's 2011-12 savings

2.2 HMRC's 2011-12 target was to reduce its running costs by £248 million, a quarter of the overall amount to be saved across the four-year spending review period. It actually made sustainable savings of £296 million, 19 per cent more than its target. This contributes around one-third towards the total four-year target (**Figure 6**). In addition, HMRC has made £127 million of one-off savings which it considers do not meet the criteria set out in paragraph 1.8 for sustainable savings. Savings that are not sustainable do not count towards HMRC's cost reduction target.

Figure 6
HMRC's performance against target in 2011-12

HMRC exceeded its target by £48 million

	Savings (£m)	Percentage of 2011-12 baseline budget (£3,548m) (%)	Contribution towards the spending review target of 25 per cent (%)
2011-12 cost reduction target	248	7	28
2011-12 outturn	296	8	33
Made up of:			
• staff cost savings; and	169		
• administration and contract cost savings	127		

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

2.3 Once adjusted for inflation, HMRC's accounts show their resource departmental expenditure limit was £204 million lower in 2011-12 than the previous year. This is what we would expect to see once all HMRC's savings, reinvestment and additional funding are taken into account. We have been able to reconcile HMRC's savings to this figure (**Figure 7** overleaf). HMRC does not reconcile its savings to its accounts as part of its year-end processes. In our report on the 2007 spending review, we made a similar recommendation in order that HMRC could demonstrate that savings actually result in reduced expenditure and are not offset by cost growth in other parts of the business.[6]

2.4 In 2011-12, HMRC made savings across its business (**Figure 8** on page 23). In line with the requirements of HMRC's settlement, corporate support functions have saved the most in absolute terms (£145.9 million). Of these savings, £74 million relate to IT (paragraphs 2.16 to 2.19).

2.5 HMRC's other strategic objectives are to maintain tax collection, collect an additional £7 billion in tax revenues by 2014-15, and to improve customer service levels. HMRC improved its performance in 2011-12 but did not meet all of its customer service targets (**Figure 9** on page 24). We and the Committee of Public Accounts recommended that HMRC model the impact of cost reduction on tax revenues and customer service over the spending review period. It is modelling the impact on tax revenues and has just started work to assess the impact on customer service.

2.6 In 2011-12 HMRC collected £16.6 billion of additional tax revenues from compliance activities, £1.6 billion more than its target. Compliance activities include both the new more complex enforcement and compliance work that HMRC is investing in, and work HMRC was already doing. HMRC collected £1.8 billion of its £2 billion target for the new work. It considers this was because it did not move as many staff into this work as forecast. However, it exceeded its target for the amount of tax collected through work it was already doing by £1.8 billion.

2.7 In 2012 HMRC started to analyse its compliance activity performance to better understand the drivers of performance and to determine whether it needed to revisit its overall compliance target of collecting £20 billion in additional tax revenues by 2014-15. Its interim report concluded it had collected more tax than expected because of factors unlikely to be repeated in future years, such as more high-value cases being settled in 2011-12 than usual. This work is ongoing. Currently, it is forecasting to meet, or slightly exceed, its 2012-13 target of £17 billion additional tax revenues. HMRC therefore does not intend to revisit its overall target.

6 Comptroller and Auditor General, *HM Revenue & Customs: Independent review of reported CSR07 value for money savings*, Session 2010-11, HC 293, National Audit Office, July 2010.

Figure 7
Reconciling HMRC's accounts and its savings

We would expect to see a difference of £204 million between the two sets of accounts

	2010-11 baseline (£m)		2011-12 (£m)
Difference between 2010-11 and 2011-12 accounts			
Resource departmental expenditure limit[1]	3,826		3,708
Exclude depreciation[2]	-208		-209
Remaining expenditure excluding depreciation	3,618		3,499
Inflated to 2011-12 prices using HM Treasury rate of 2.34%[3]	3,703		3,499
Difference			**204**
Reconciliation with savings achieved in 2011-12			
Total savings			423
Made up of:			
• Sustainable savings		296	
• one-off savings (not counted towards cost reduction target)		127	
Less one-off savings redeployed to meet other objectives			33
Less planned reinvestment in compliance activity			101
Less additional funding[4] for:			
RTI;			18
Redundancy; and			33
Changes to child benefit			34
Total			**204**

NOTES

1 Figures include the core department of HMRC only and do not include the Valuation Office Agency (VOA), which is an executive agency of HMRC.

2 HMRC's savings target does not include depreciation therefore this has been excluded. HMRC's accounts show depreciation relating to both Departmental Expenditure Limit (DEL) and Annually Managed Expenditure (AME) together. Amounts excluded here are only in relation to DEL.

3 Figures are based on the HM Treasury inflation rate for the year. This assumes inflation at the same rate on all costs and does not take into account specific variations such as higher rates of inflation on PFI contracts and the salary freeze imposed on civil service salaries.

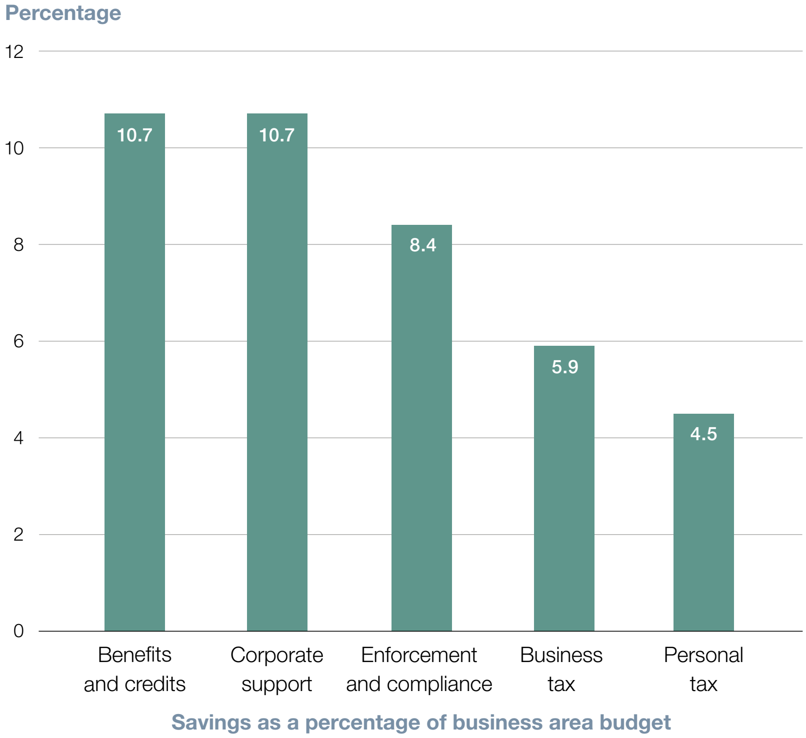
4 Amounts as agreed in HMRC's 2010 Spending Review settlement letter.

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

Figure 8

2011-12 cost reductions from each business area as a percentage of its budget

All business areas have made savings



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

2.8 We reported on HMRC's customer service performance in December 2012.[7] HMRC has restored its performance from a low point in 2010-11. We concluded that HMRC's customer service arrangements currently represent poor value for money for customers, despite some welcome improvements. HMRC's performance against its 2011-12 customer service targets was not a consequence of cost reduction. It is still recovering from problems it encountered when introducing the new National Insurance and PAYE Service (NPS) in 2009-10, which we have previously reported on.[8] It will be challenging for HMRC to make more and deeper reductions and maintain customer service, especially as it introduces RTI.

7 See footnote 2.

8 Comptroller and Auditor General, *HM Revenue & Customs Annual Report and Accounts 2011-12*, Session 2012-13, HC 38, National Audit Office, June 2012.

Figure 9
HMRC's performance across a range of measures

HMRC has improved its performance across a range of measures but has not met all its customer service targets

	2010-11		2011-12	
Performance measure	**Target**	**Actual**	**Target**	**Actual**
Tax collected (£bn)	n/a	468.9	n/a	474.2
Tax collected from compliance activities (£bn)	13.9	13.9	15	16.6
Debt balance (£bn)[1]	n/a	19.3	n/a	15.4
Calls handled (%)[2]	75	48	58	74
Post received by HMRC cleared within 15 working days of receipt (%)	80	51	80	66
Post received by HMRC cleared within 40 working days of receipt (%)	95	85	95	92

NOTES

1 The debt balance refers to tax debt which HMRC is actively managing.

2 Internal indicator. HMRC has not published a formal target for calls answered in 2011-12.

Source: HM Revenue & Customs

How HMRC made savings

2.9 HMRC has made savings through reducing staff costs (£169 million) and administration and contract costs (£127 million).

Reducing staff costs

2.10 HMRC has made staff cost savings of £169 million by doing the following:

- It increased productivity and efficiency, which frees up staff time to do more important work or enables HMRC to reduce how many staff it employs. It increased productivity by reducing management layers, working more efficiently or stopping low value or unnecessary work (£126 million) and reducing sickness absence (£13 million).
- It kept salary costs the same following the government's salary freeze (£29 million).

2.11 By increasing productivity, HMRC has reduced the total number of permanent full-time equivalent staff between 2010-11 and 2011-12 by 2,376.

Improving productivity

2.12 HMRC has made most of its productivity improvements using a business improvement technique called PaceSetter.[9] PaceSetter encourages staff to identify areas where processes could be improved to eliminate waste and duplication, or to find alternatives to the current way of working which may be more effective. Relatively small changes can have an impact on productivity, leading to efficiency savings where staff may not need to be replaced as they leave, or can be freed up to do other work, avoiding the need to recruit new staff. HMRC attributes just over £99.4 million of its efficiency savings in 2011-12 to efficiency measures it has introduced by using PaceSetter and other process improvement techniques. See **Case example 1** for an example of PaceSetter in practice.

2.13 HMRC has only a limited understanding of the costs and value of its work. This has meant that it has not been able to track improvements from PaceSetter activities into savings. We found that savings attributed to PaceSetter are often balancing figures after other, more easily identifiable, savings have been removed. In the enforcement and compliance area, often HMRC was not able to track how activities such as PaceSetter had led to it being able to live within its reduced budget. After it had accounted for improvements in sickness absence, staff productivity increases from change projects, and organisation design, the remaining £72 million of savings were attributed to PaceSetter.

2.14 HMRC has also made savings from using staff more effectively. The ‘future service delivery’ project in the personal tax business area made savings of £13.5 million in 2011-12 through a range of changes to use staff better, for example changing opening hours in enquiry centres to better reflect when customers used the centres, therefore freeing up staff time. However, it took until September 2012 for the project team and business area to agree that savings had been made by making these changes because of difficulties in tracking where staff had gone. The business area now has a better process for monitoring savings.

Case example 1
Enforcement and compliance PaceSetter example

HMRC’s VAT DIY team deals with VAT refunds for those who build their own homes or convert non-residential dwellings into homes. The team was receiving a large number of customer calls which had created a backlog of work. Rather than bringing in extra staff to answer the calls, they applied Pacesetter techniques to identify why customers were calling.

The team found that HMRC’s website did not have frequently asked questions on VAT DIY refunds, but did include a telephone number. An analysis of the calls showed that most queries were similar and straightforward to answer.

The team developed a frequently asked questions page for the website and succeeded in reducing calls by 40 per cent, allowing them to concentrate on processing refunds and dealing with more complex queries, removing the need to recruit new staff.

9 Comptroller and Auditor General, *PaceSetter: HMRC’s programme to improve business operations*, Session 2010–2012, HC 1280, National Audit Office, July 2011.

Reducing administration and contract costs

2.15 In 2011-12, HMRC saved £127 million in administration and contract costs, 79 per cent of which came from reductions in IT and estates costs.

Reducing IT costs

2.16 HMRC outsources most of its IT support and development to a consortium of suppliers through the ASPIRE contract, signed in 2004 and due to end in 2017. In 2009 HMRC renegotiated the contract to reduce running costs by £161 million a year from 2011-12 through a combination of reducing service charges, reducing the prices paid for laptops and hardware and managing the IT contract more efficiently. It had made £47 million of savings before the spending review, therefore it had a target to save £114 million in 2011-12. These savings were not included in the baseline as they had not yet been made.

2.17 HMRC made savings of £111 million in 2011-12 (**Figure 10**). Of this, HMRC counted £74 million towards its spending review savings target. The remaining £37 million related to reductions in capital expenditure which is not part of HMRC's spending review savings target (see footnote 3).

Figure 10
HMRC's 2011-12 IT savings

HMRC made £111 million of IT savings compared with a target of £114 million

	2011-12 outturn (£m)	Target (£m)
Reduction in service charges	42.7	50
Price reductions	60.1	49
Better contract management[1]	8.4	15
Total	111.2	114
Less capital savings	37.1	
Total savings counting towards the spending review[2]	74.1	

NOTES
1 HMRC has already made £47 million of IT savings and these were included in the 2010-11 baseline.
2 HMRC's spending review settlement does not cover capital savings, see footnote 3.

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

2.18 HMRC's sustainable IT savings apply only to the administration expenditure element of the accounts. IT administration spend has increased by £22 million between 2010-11 and 2011-12, despite HMRC making savings of £74 million. This was because in 2010-11 HMRC received £48 million in credits from its contractors for, for example, using equipment for longer than its expected useful life. These credits either did not recur in 2011-12, or were for less than in 2010-11. It also received £10 million less income in 2011-12 than in the previous year from other government departments that had used HMRC's IT services. Inflation built into the contract, which runs at a higher rate than normal inflation, increased the cost by £22 million, and management charges increased by £14 million.

2.19 HMRC continues to seek savings from its IT procurement. In March 2012 HMRC and its ASPIRE partners signed a memorandum of agreement to create a different way of working. This would include introducing direct competition for HMRC work from outside the ASPIRE partners, seeking to make savings of £200 million by 2017. HMRC has not yet included all the financial benefits from securing this further change in its savings plans to 2014-15 as it has yet to finalise its estimate of which savings are sustainable. HMRC expects to progress beyond the memorandum of agreement to formally change the contract in late 2012-13.

Reducing estates costs

2.20 More than 60 per cent of HMRC's estate is procured through a 20-year contract with Mapeley, running from 2001 to 2021. The remainder of HMRC's estate consists of private finance initiative (PFI) deals on specific buildings and properties rented from other landlords and government departments. We reported on the operation of the STEPS contract in 2009.[10] We concluded that HMRC had not yet achieved value for money from the contract as it had not realised all the benefits available from the deal. We recommended that HMRC strengthen how it managed the contract. We also recommended that it put in place a long-term estates strategy for using provisions in the contract to vacate properties it no longer needed to save money.

2.21 Since our report, HMRC has put in place a long-term strategy covering its entire estate. There are three stages, the first of which corresponds to the spending review period. Its targets are to do the following by March 2015:

- Reduce the cost of maintaining the estate by £72 million (20 per cent).
- Reduce the size of the estate by 300,000m^2.
- Improve performance against the government property efficiency benchmark of 8 to 10m^2 per full-time equivalent staff member by reducing its space per full-time equivalent from 15.06m^2 at March 2011 to 14.21m^2 by March 2015. The reduction will reflect both more efficient use of space and a reduction in staff numbers.
- Reduce the number of HMRC office locations from 141 to 125.

10 Comptroller and Auditor General, *HM Revenue & Customs' estate private finance deal eight years on*, Session 2009-10, HC 30, National Audit Office, December 2009.

2.22 When we and the Committee of Public Accounts[11] reported, we were particularly concerned that HMRC did not fully understand Mapeley's financial position and profitability. This limited HMRC's ability to manage risks, negotiate effectively and develop a functioning partnership and we recommended that it seek access to full financial information. At the Committee's hearing, Mapeley committed to giving HMRC full access to financial information. HMRC now understands Mapeley's financial position and has improved its overall management of the contract and relationship with Mapeley.

2.23 In 2011-12, HMRC achieved its target of making £26.8 million of savings from reducing estates costs. HMRC made savings through a combination of vacating properties entirely and reducing its estate. HMRC made informed decisions about reducing the estate, based on cost and management information, including resourcing requirements. **Case example 2** includes examples of its decision-making.

2.24 Estates spend shown in HMRC's accounts has reduced between 2010-11 and 2011-12 by £18 million, despite HMRC making total savings of £26.8 million. The difference is partly because utility costs rose above the level of inflation, offsetting some of the savings, and partly because HMRC recovered £7 million of VAT as a saving, which is not shown in the estates line of the expenditure note in the accounts.

Case example 2
Estates rationalisation examples

HMRC analysed whether it would be more cost-effective for staff to move from smaller buildings into the large Queen's Dock building in Liverpool, or to vacate Queen's Dock and move those staff into smaller buildings. It found it was more cost-effective to vacate Queen's Dock, saving £5.5 million.

In Chesterfield, there were strong financial arguments for closing and vacating the building altogether. However, the teams based there raised concerns that this would result in disruption, potentially losing skills in high-value enforcement and compliance work, which could compromise HMRC's efforts to reduce the tax gap as there were no other offices nearby. As a result, HMRC retained the building.

HMRC has also made difficult decisions to vacate buildings on cost grounds, despite disruption to the business. A property in Stockport was part of a PFI contract due to end in 2013-14. HMRC considered it expensive at approximately £6,600 per full-time equivalent staff member, 50 per cent above the HMRC average. The business teams did not want to disrupt frontline work or lose expertise. However, the scale of the cost benefit was such that business teams agreed to the closure, using other office space HMRC and the Department for Work and Pensions occupied in the surrounding area.

11 HC Committee of Public Accounts, *HMRC's estate private finance deal eight years on,* Thirty-second Report of Session 2009-10, HC 312, March 2010.

Part Three

Readiness for future savings

3.1 HMRC has a track record of making savings, achieving its spending targets and living within its budget. Since it was created in 2005, it has saved £1.7 billion, reducing its permanent headcount from some 95,000 full-time equivalents to 64,500 at the end of 2011-12.

3.2 HMRC will need to ensure that the cost savings it makes are sustainable in the long term so that it can continue to operate at a lower cost base. This part of the report considers how well positioned HMRC is to make future savings and covers:

- HMRC's vision for the future;
- its plans to make further savings; and
- the governance and programme management of the change programme.

HMRC's vision

3.3 Our work on cost reductions across government[12] and work from other parties[13] found that in order to not only cut costs but also maintain a lower cost base, change programmes should focus on transformational change.

3.4 HMRC understands the need to change and redesign its processes to transform its business and operate at a lower cost. It is moving from tactical efficiency savings and quick wins towards a more strategic approach to using and optimising its resources. Since the spending review, it has been developing options for changing its business more radically, which could help it further reduce costs. It does not yet have a target operating model for beyond 2014-15. Its current cost reduction plans are to shift resources into enforcement and compliance work and reduce staff time required to help those who pay their tax voluntarily. These plans are consistent with HMRC's long-term vision for efficient and effective tax administration. However, a clearer articulation of its vision would enable HMRC to regularly monitor that it is on the most appropriate path to cut costs without compromising this vision.

12 National Audit Office, *A short guide to structured cost reduction*, 2010 and Comptroller and Auditor General, *Cost reduction in central government: a summary of progress*, Session 2010-12, HC 1788, National Audit Office, February 2012.
13 The Boston Consulting Group, *Why it's so hard to cut costs in government*, May 2012, and McKinsey & Co *Five ways CFOs can make cost reductions stick*, May 2010.

HMRC must cut costs by a further £585 million by 2014-15

3.5 In the first year of the four covered by the spending review, HMRC has made 31 per cent (£296 million) of the total cost reduction of £955 million it requires by 2014-15. It has also carried over £74 million of staff savings into 2012-13. Assuming all these savings are sustainable, it has to make further cost reductions of £585 million by the end of the spending review period (**Figure 11**). At September 2012, HMRC was on track to exceed its 2012-13 cost reduction target by £29 million.

3.6 HMRC plans to make savings through change projects and efficiencies identified by business areas (see Figure 3 in Part One). When we last reported, HMRC planned to make 60 per cent of its savings from change projects (£573 million) and 40 per cent (£382 million) from efficiencies (**Figure 12**). It is now forecasting to make savings of £411 million from change projects, £162 million less than planned. This is partly because HMRC has refined initial forecasts and made them more realistic using more robust benefits and cost data. Some projects were slower to start, making them less likely to realise all planned benefits within the spending review period. To mitigate this, HMRC reprioritised investments to maximise its ability to make savings.

Figure 11
Profile of savings 2011-12 to 2014-15

HMRC needs to make new cost reductions of £585 million by 2014-15

When new savings begin and percentage of total new savings	2011-12 Actuals realised (£m)	2011-12 Actuals carried forward to 2012-13 (£m)[1]	Total 2011-12 savings achieved (£m)	2012-13 forecast (£m)	2013-14 forecast (£m)	2014-15 forecast (£m)	Savings remaining to be made (£m)	Total (£m)	Total (%)
Savings from 2011-12	296	74	370	370	370	370	585	**1,480**	**58**
New savings from 2012-13	–	–	–	118	118	118	467	**354**	**14**
New savings from 2013-14	–			–	235	235	232	**470**	**19**
New savings from 2014-15	–			–	–	232	–	**232**	**9**
Total savings per year	296	74	370	488	723	955	–	**–**	**–**
Cumulative savings	**296**	**74**	**370**	**858**	**1,581**	**2,536**	**–**	**2,536**	**100**

NOTES
1 HMRC has carried over £74 million of savings relating to staff salaries from 2011-12 into 2012-13.
2 HMRC does not propose to adjust savings already achieved for inflation.

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

Figure 12

Difference between HMRC's original savings forecasts and its current plans

HMRC has to save £66 million more than it planned from efficiencies

	HMRC forecast at 2010-11 Saving (£m)	Percentage of £955 million target (%)	Forecast at 30 September 2012 Saving (£m)	Percentage of £955 million target (%)
Change projects	**573**	**60**	**411**	**43**
Efficiency savings	**382**	**40**	**448**	**47**
Made up of:				
• efficiency savings in enforcement and compliance area	228	24	229	24
• efficiency savings in all other business areas	154	16	219	23
Salary freeze forecast			**96**	**10**
Total	**955**		**955**	

NOTE

1 In 2010-11, HMRC included the salary freeze forecast within its change project and efficiency savings forecasts.

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

3.7 HMRC has benefited from the salary freeze imposed by the government, which will enable it to make savings of £96 million by 2014-15. To achieve its target of reducing costs by £955 million, savings from its IT contract renegotiation, PaceSetter, other productivity improvements and from reducing sickness absence have become increasingly significant. These now account for £448 million of the total to be saved, £66 million more than HMRC originally planned.

3.8 The plans for achieving savings from productivity improvements are less well formulated than those related to change projects and there is less certainty around how the business will generate the required savings without impairing performance. In 2012-13 HMRC expects to realise savings through similar activities to those in 2011-12, such as PaceSetter and absence management, but there is little detail on the plans beyond April 2013. HMRC finds it difficult to track savings relating to efficiencies, such as those from PaceSetter (see paragraphs 2.12 to 2.14).

Some savings depend on significant business change

3.9 HMRC's change programme is ambitious and depends on significant coordination across the department. In particular, many projects are interdependent and savings in one area rely on business change in another.

Reducing staff in personal tax

3.10 The personal tax business area plans to reduce its staff by 8,500 full-time equivalents. HMRC plans to shift the majority of these into tackling avoidance and evasion (see Figure 4).

3.11 The personal tax business area has two main change projects to reduce staff numbers.[14] The demand management project aims to save 3,930 full-time equivalents by reducing the need for customers to contact HMRC through eliminating unnecessary contact and moving contact online. The future service delivery project aims to save some £163 million, equating to 2,660 full-time equivalent staff by 2014-15 by:

- increasing flexibility by redeploying back-office staff to answer calls at peak times; and
- developing targeted support for customers who need help.

3.12 It is vital that the personal tax business area release staff into enforcement and compliance as forecast. While it achieved its forecast of reducing staff by 1,477 in 2011-12, it did not release as many staff into the enforcement and compliance area as planned because its approach at that time was to move people individually or on promotion into new roles. This took more time than expected and meant that HMRC could not move as many staff onto reinvestment-funded work as planned in 2011-12. It considers that this is the reason it missed its £2 billion target for this new work by £200 million (see paragraph 2.6). HMRC has learnt from its experience and is now moving whole teams, and says it is on track to move the forecast number of staff in 2012-13.

3.13 At the same time as reducing staff in personal tax, HMRC has redeployed some staff within personal tax and employed temporary staff to deal with customer contact. It has employed 2,500 temporary staff at a cost of £53 million to deal with backlogs resulting from introducing NPS. HMRC expects these staff to leave by September 2013 when the backlogs are clear. HMRC also plans to deploy up to 1,000 temporary additional contact centre staff between now and 2013-14, at a cost of £34 million, to help it meet its target of answering 90 per cent of calls by March 2013, two years earlier than planned. The decision stemmed from concerns over the reputational risk if HMRC did not make rapid improvements. It is funded from additional savings made across HMRC in-year. These staff will be in place until March 2014. After that HMRC anticipates that it will no longer need them as it will have fully implemented its plans to reduce demand, use resources more flexibly and improve efficiency.

14 See footnote 2.

Reducing sickness absence

3.14 In 2011-12, HMRC succeeded in reducing the working days it lost to sickness absence from 9.77 to 7.64 days per full-time equivalent staff member, saving the equivalent of £13 million of unproductive time. It did this by:

- tackling long-term sickness absence to support people back into work or to let them go;
- putting in place measures so that managers actively manage sickness absence; and
- targeting activities at particular areas with high sickness absence or specific types of absence.

3.15 In formulating its original cost reduction plans, HMRC did not model how it could reduce sickness absence rates, but introduced a target to reduce average sickness absence per full-time equivalent employee by two days. It is now modelling how sickness absence rates may change, taking into account, for example, managing absence better, tackling locations with high absence rates or particular types of absence. Currently, the model predicts that sickness absence should continue to decrease in 2012-13. However, maintaining lower levels of sickness absence will require constant active management across HMRC.

Reducing the size of the estate

3.16 HMRC forecasts future savings from its estates strategy of £58.9 million over the remaining three years of the spending review period. Achieving these savings depends on HMRC reducing staff numbers as forecast and being ready to vacate buildings.

3.17 HMRC has a workforce management programme to manage staff moves. This includes determining what staff are required and when, and ensuring that they have the right training and equipment. Moving staff can mean that offices can be vacated and closed, or that space can be reduced and better used. The director of estates and support services sits on the workforce management programme board and all decisions about changes to the estate are made together with this board. This helps to mitigate the risk of office closures occurring at the wrong time.

Governance and programme management arrangements

3.18 The size and scale of HMRC's change programme requires robust governance and programme management.

HMRC's portfolio management approach

3.19 We and the Committee of Public Accounts recommended[15] that HMRC should have contingency plans to mitigate the risk of not achieving its savings. HMRC manages the change programme as a portfolio to address concerns about contingency. By looking across the portfolio, the change programme office considers all projects, whether related to cost reduction, customer service or increasing tax revenues, as a group. This creates flexibility which HMRC's investment committee is able to use when making investment decisions. For example, if projects are not achieving as expected then HMRC can stop or defer them, and accelerate other projects or consider new ones in their place.

Managing spending and risk through reprioritisation

3.20 To manage the risk of projects not delivering or over- or underspending, HMRC's portfolio management approach includes a reprioritisation exercise. Towards the end of 2011-12, the investment committee decided to perform this on a quarterly rather than a six-monthly basis to maximise its ability to assess whether projects are meeting HMRC's priorities.

3.21 HMRC allocates projects to a priority group according to criteria which reflect its investment priorities. The priority groups are projects that are legally or contractually committed, meet ministerial requirements, or are publicly announced. As at 30 September 2012, the total funding required to 2015 for projects in these three groups is £817 million, 77 per cent of the total funding available.

3.22 While HMRC also challenges funding for projects in the priority groups, its main flexibility is in the lower priority projects, which the investment committee ranks and prioritises according to how far they contribute towards HMRC's strategic objectives. Performing the reprioritisation exercise more frequently helps HMRC to maximise the available flexibility but it requires continuous monitoring.

3.23 In 2011-12, HMRC did not manage to progress some change projects as far as it had expected. Consequently, HMRC underspent on its change programme budget by £100 million. This was partly because it took HMRC longer than expected to advance business cases to the point where funding could be approved. It was also because HMRC did not spend its allocated reinvestment funding as it shifted fewer staff than expected into more complex enforcement and compliance activities (paragraphs 2.6 and 3.12).

15 See footnote 5.

3.24 To ensure the full use of limited capital funding in 2012-13, HMRC over-allocated funding in the early part of the year as projects tend to underspend against forecast. This presents the risk of HMRC overspending should all projects spend as forecast. HMRC considers its reprioritisation exercise enables it to mitigate this risk by stopping projects if necessary.

Understanding interdependencies

3.25 The Committee of Public Accounts and NAO reports[16] highlighted the need for HMRC to better understand the interdependencies between projects. The scale of the changes means that there are complex interdependencies as many projects are enablers for others. For example, reducing the estate depends on projects across HMRC reducing staff to enable it to vacate space (paragraphs 3.16 and 3.17). HMRC needs to understand interdependencies to ensure that the sequencing of projects enables smooth implementation.

3.26 HMRC has carried out high-level work on interdependencies, but it is still immature considering HMRC is almost halfway through the four-year spending review period. Projects that are key enablers for other projects are categorised by the investment committee as higher priority. However, it is less clear that HMRC fully understands the interdependencies between those projects that are not in the key enabler category. Individual project managers must identify interdependencies rather than them being identified and managed at a strategic level. This presents the risk that HMRC does not identify all interdependencies, nor take action to ensure the correct sequencing to achieve its objectives.

Projects to transform business processes and to save costs

3.27 HMRC has begun projects to transform business processes and save costs. It is transforming organisation-wide and operational processes. HMRC has examined all its high-level processes to identify end-to-end costs and opportunities for redesign using what it calls the 'enterprise-level process model'. However, HMRC does not expect the model to produce any savings until the latter part of the spending review. It is using PaceSetter to identify areas of waste and duplication and eliminate them to save costs and improve customer service.

3.28 HMRC is optimistic that some of the changes it is making will allow it to make significant savings. For example, as part of its PaceSetter activities, it is trialling a new way of dealing with compliance risks identified in tax returns from businesses. However, the team running the trial do not yet consider there is enough robust data to forecast the level of savings that may be made.

16 See footnote 5.

Appendix One

Our audit approach

1 This report provides an independent opinion on whether HMRC is well placed to achieve value for money from its cost reductions given progress to date. To undertake this study we examined:

- whether cost reduction is integrated into HMRC's wider change programme;
- whether HMRC fully understands the cost reductions and the impacts they may have;
- whether the plan for cost reductions is well designed and whether the savings are sustainable; and
- whether HMRC has built robust risk management into the programme.

2 Our audit approach is summarised in **Figure 13**. Our evidence base is described in Appendix Two.

Figure 13
Our audit approach

The objective of the Department

HMRC has an objective to reduce running costs by 25 per cent by 2014-15 while at the same time increasing tax revenues and improving or at least maintaining customer service.

How this will be achieved

HMRC has set up a change programme comprising specific projects to change the way in which HMRC operates and other measures to improve productivity and efficiency to drive down costs.

Our study

The study examined HMRC's progress on reducing costs to date and, given that progress, whether it is well placed to achieve value for money from its cost reductions over the spending review period.

Our evaluative criteria

Cost reduction forms part of a wider change programme aimed at changing the way in which HMRC operates.

HMRC has a good understanding of the cost reductions achieved so far and those required in the future, and their impacts on performance.

HMRC's cost reduction programme has been robustly designed, implemented and monitored, and the cost reductions are sustainable.

HMRC has assessed the risks to future value for money from its cost reductions and has put in place plans to mitigate these risks.

Our evidence

(see Appendix Two for details)

We examined how HMRC's cost reductions fit into its wider change programme by:

- drawing on previous NAO work;
- reviewing business plans and strategies;
- reviewing the operation of the change programme and its management and implementation;
- attending internal committee meetings; and
- reviewing work done on the change programme by internal audit.

We analysed HMRC's achievements and the plans for the future by:

- selecting five case study areas to review in depth;
- performing financial analysis on the savings made so far; and
- performing reviews of the costing and sensitivity analysis included in business cases.

We examined the cost reduction programme and the sustainability of the savings by:

- selecting five case study areas to review in depth;
- analysing and reviewing HMRC's work undertaken on modelling to forecast likely future savings;
- reviewing the assurance work undertaken on the programme; and
- reviewing internal audit validation work.

We examined HMRC's readiness to make future savings by:

- reviewing the change programme project management and governance arrangements;
- selecting five case study areas to review in depth; and
- performing a review of the modelling undertaken by HMRC on specific parts of the change programme.

Our conclusions

HMRC has made good progress in creating the conditions to achieve cost reductions, and has improved its cost-effectiveness and value for money since our last report in July 2011:

- It has put in place and is using strong governance arrangements.
- It has achieved its cost reduction targets for 2011-12 and is on track to deliver its 2012-13 targets.

However, HMRC has much work to do to ensure it achieves value for money from future savings:

- Its understanding of costs and the value of its activities across the organisation is not yet sophisticated, undermining HMRC's ability to identify and implement sustainable cost savings.

Appendix Two

Our evidence base

1 Our independent conclusions on whether HMRC's cost reductions are delivering value for money were reached following our analysis of evidence collected between May and November 2012.

2 We applied an analytical framework with evaluative criteria which consider what arrangements would be optimal to achieve cost reductions while at the same time maintaining performance. Our audit approach is outlined in Appendix One.

3 **We assessed whether cost reduction forms part of a wider change programme aimed at changing the way in which HMRC operates:**

- We assessed HMRC's cost reduction plans for the spending review period and the achievement of its cost reduction targets in 2011-12.
- We drew on our **previous and ongoing work** collating all existing NAO evidence relevant to cost reduction both within HMRC and across government, including reviews of recent value-for-money studies and liaison with colleagues in the process of conducting relevant work.
- We conducted a **file review** of published and internal client documents, including:
  - Published documents
  - The annual report and accounts
  - Business plans and strategies
  - Internal documents
  - Management accounts
  - Internal audit reports
  - Internal business functions' plans
  - HMRC committee papers and minutes
  - Change programme documents, including risk register, financial documents and benefits management documents
  - Business cases for change projects.

- We **liaised with HMRC Internal Audit** and drew on their work on the cost reductions made in 2011-12.

4 We assessed whether HMRC had a good understanding of the cost reductions achieved so far and those required in the future, and their impact on performance.

- We selected five areas of cost reduction to review in depth as case studies. These were:
  - the 2009 renegotiation of the Aspire IT contract;
  - the programme for reducing HMRC's estate costs;
  - the future service delivery project in the personal tax area, designed to bring more flexibility in the delivery of back-office and telephone services;
  - reducing sickness absence; and
  - increasing productivity and efficiency in the enforcement and compliance function to enable redeployment of staff into more complex work.
- The work on these case study areas included semi-structured interviews with project managers and key project personnel, in-depth analysis of relevant documentation and business cases, financial analysis and a review of modelling work performed (see paragraphs below).
- We performed financial analysis to validate HMRC's claimed savings:
  - We reviewed the reasonableness of HMRC's method for calculating the savings made from reducing the numbers of full-time equivalent staff or redeploying them to more productive work, and re-performed their calculation.
  - We reviewed HMRC's criteria for counting savings as 'efficiency savings' that they count towards their cost reduction target.
  - We performed a reconciliation between HMRC's identified cost reductions and their annual accounts.

5 We examined whether HMRC's cost reduction programme had been robustly designed, implemented and monitored, and whether the cost reductions are sustainable.

- We reviewed HMRC's modelling for specific parts of the cost reduction programme:
  - We viewed the Compliance Resource Allocation Model to consider the relationship between numbers of staff and HMRC's ability to collect revenue and interviewed the staff who had developed it.
  - We viewed the model being developed to forecast movements in sickness absence rates, analysed the information used to inform the model and interviewed staff involved in developing it.
  - We performed financial analysis to assess the financial decisions taken by the investment committee. We reviewed the financial information, sensitivity analysis and costing information presented to the investment committee as part of project business cases.

6 We examined whether HMRC had assessed the risks to future value for money from its cost reductions and had put in place plans to mitigate these risks.

- We conducted a review of the management of HMRC's change programme, including reviewing the progress made against our previous recommendations. In particular, we examined the following areas:
  - risk management;
  - contingency planning;
  - interdependencies between projects;
  - governance arrangements; and
  - leadership and staff engagement.
- We conducted a review of the management of the central change programme. We held semi-structured interviews with key personnel within the programme, and analysed documentation including financial information, risk management information and details of assurance activity undertaken.

- We conducted semi-structured interviews with personnel responsible for the longer-term 2020 Vision, which outlines HMRC's long-term future plans.
- We observed internal committee meetings on change and investment.
- We reviewed the portfolio management approach and the investment committee's reprioritisation exercise designed to manage projects together as a group and reprioritise them according to changes in circumstances in place of having a contingency built into the programme.
- We reviewed HMRC's work to identify the interdependencies which exist between different projects.

Appendix Three

How HMRC is organised

1 HMRC is organised into three groups (business tax; benefits and credits; personal tax) which are responsible for tax or benefit regimes. A fourth group (enforcement and compliance) provides a range of specified cross-HMRC operations. The groups are supported by five department-wide corporate services functions. The leaders of these groups and functions, together with the chief executive, form the executive committee (see **Figure 14**).

Figure 14
How HMRC is organised

HMRC has ten operational business areas

Executive committee

Business tax

Responsible for administering and collecting taxes paid by businesses including corporation tax, VAT and other excise duties

Benefits and credits

Responsible for administering and paying out tax credits and child benefit

Personal tax

Responsible for administering and collecting taxes paid by individuals, including income tax and national insurance. Also runs HM Revenue & Customs' contact centres and post offices, and HMRC's digital services

Enforcement and compliance

Responsible for tackling tax evasion and avoidance, including debt management and banking, compliance activities and investigations

Tax assurance, change and corporate services

- Tax assurance commissioner group responsible for tax policy and professionalism, and overseeing large tax settlements. Also includes analysis and customer strategy functions
- Finance group, including procurement and estates
- Information management services
- Human resources
- Legal
- Change programme

Source: HM Revenue & Customs

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