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# *Commissioners for Revenue and Customs Bill*

**Bill 3 of 2004-05**

The *Commissioners for Revenue and Customs Bill* 2004-05 was introduced in the Commons on 24 November 2004. It is expected to be debated on second reading on 8 December 2004.

The main purpose of the Bill is to integrate the Inland Revenue and HM Customs and Excise to form a single department: HM Revenue and Customs (HMRC). The Chancellor of the Exchequer, Gordon Brown, announced the merger in his 2004 Budget on 17 March 2004. Merging the Revenue and Customs was the central recommendation of a review of the revenue departments and the Treasury chaired by Gus O'Donnell, permanent secretary to the Treasury.

This paper discusses the background to the O'Donnell review and reactions to its proposal for a merger, before looking at the response to the Government's introduction of legislation to effect this change.

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## Summary of main points

In his 2004 Budget speech the Chancellor Gordon Brown announced that the Government would merge HM Customs & Excise with the Inland Revenue into a single department: Her Majesty's Revenue and Customs.<sup>1</sup> This followed the recommendation of a review chaired by Gus O'Donnell, permanent secretary to the Treasury,<sup>2</sup> which had been set up in July 2003 to review the three organisations dealing with tax policy and administration: Customs, the Revenue and HM Treasury.<sup>3</sup> The O'Donnell review – as it is commonly known – was published alongside the Budget; its key recommendations included:

- creation of a new department, integrating HM Customs and Excise and the Inland Revenue, tasked with improving customer services, particularly reducing compliance costs, improving compliance with tax law, and increasing efficiency;
- clearer roles and responsibilities for tax administration within a new accountability framework and annual remit laid down by Ministers; and
- transfer of tax policy functions to the Treasury, to improve the ability of the Government to respond to modern tax challenges and create a greater delivery focus in the new department.<sup>4</sup>

The *Commissioners for Revenue and Customs Bill* was introduced on 24 November 2004, and published the same day along with explanatory notes on the Bill [Bill 3-EN]. The purpose of the Bill is set out in a background note published by the Treasury:

The Bill is central to the Government's objectives and reform agenda as it creates an organisational framework for delivering real improvements to tax administration. The Bill would integrate the Inland Revenue and HM Customs and Excise to form a single, new department to be named HM Revenue and Customs (HMRC) — implementing the key recommendation from the O'Donnell review of revenue administration ... The Bill would also create a new prosecutions office to prosecute HMRC cases in England and Wales, implementing a key recommendation of the Butterfield report of July 2003.

Through delivering a single Department, the Bill would:

- Deliver improvements for customers through more joined up services in a single Department, and deliver a more effective and efficient tax administration, including improved customer service and revenue collection.
- Enable the new department to meet its demanding Public Service Agreements and realise efficiency savings, with integration contributing 3,000 posts towards total savings in HMRC of 16,000 posts by 2007/08.

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<sup>1</sup> HC Deb 17 March 2004 c 331

<sup>2</sup> HM Treasury, *Financing Britain's future: review of the revenue departments*, Cm 6163 March 2004. It is available at: [http://www.hm-treasury.gov.uk/budget/budget\\_04/associated\\_documents/bud\\_bud04\\_odonnell\\_index.cfm](http://www.hm-treasury.gov.uk/budget/budget_04/associated_documents/bud_bud04_odonnell_index.cfm)

<sup>3</sup> HM Treasury press notice 78/03, 2 July 2003; HC Deb 2 July 2003 cc 270-1W

<sup>4</sup> HM Treasury press notice 27/04, 17 March 2004

- Improve fairness by making information pooling easier and therefore helping to target compliance activities. This will reduce the compliance burden on honest taxpayers and make life more difficult for those who try to avoid their obligations.

Through establishing an independent prosecutions office, the Bill would:

- Enhance the role of the independent prosecutor which, along with new external scrutiny of HMRC criminal investigation work, will improve standards and effectiveness and improve public confidence in prosecutions.
- Make the staff of the office, through the Director, accountable to the Attorney General for their effectiveness.<sup>5</sup>

The Treasury has published a regulatory impact assessment on the Bill which concluded that “the new department should be established as soon as possible, through an early, short Bill containing the key provisions essential to create it and enable it to be effective.”<sup>6</sup> It is estimated that the merger “will lead to initial costs of around £75 million over the two financial years 2004/2005 and 2005/2006.”<sup>7</sup>

National taxation is a reserved matter. The HMRC is to have sole responsibility for revenue and tax credit functions across the UK. The remit of the new Revenue and Customs Prosecutions Office (RCPO) will cover England and Wales only. The present prosecutions arrangements for Scotland and Northern Ireland remain unchanged; in each, prosecutions are in the hands of a wholly independent agency: the Crown Office and Procurator Fiscal Service (in Scotland) and the Director of Public Prosecutions (Northern Ireland).<sup>8</sup>

In addition to this paper Library standard notes discuss two related issues: earlier debates about merging the UK’s tax authorities;<sup>9</sup> and a series of failed Customs prosecutions which led to the proposal for a new prosecutions office in the Butterfield report of July 2003.<sup>10</sup> As with other Library standard notes, both are published on the Commons intranet.

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<sup>5</sup> HM Treasury press office, *Queen’s Speech background note: integration of the Inland Revenue and Customs and Excise*, 23 November 2004

<sup>6</sup> HM Treasury, *Regulatory Impact Assessment: the Commissioners for Revenue and Customs Bill*, November 2004 para 69. Available at: [http://www.hm-treasury.gov.uk/media/6BB/48/RIA\\_CRC\\_211104.pdf](http://www.hm-treasury.gov.uk/media/6BB/48/RIA_CRC_211104.pdf)

<sup>7</sup> Bill 3-EN para 284

<sup>8</sup> for a summary of these arrangements see, *Review of criminal investigations and prosecutions conducted by HM Customs and Excise: report by the Honourable Mr Justice Butterfield*, 15 July 2003 pp 218-224

<sup>9</sup> “Merging the Inland Revenue and HM Customs & Excise – earlier debates”, Library standard note SN/BT/106, 26 November 2004

<sup>10</sup> “HM Customs & Excise prosecutions”, Library standard note SN/BT/2944, 26 November 2004

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## I Recent discussion of a merger

### A. The development of the ‘Closer Working’ programme

In a recent lecture to the Institute of Chartered Accountants, Gus O’Donnell, permanent secretary to the Treasury observed “integration of the two departments has been talked about for over 140 years” noting that in 1889 “Gladstone came round to the view that ‘the nature of the duties seems to me to point to amalgamation rather than the continuation of a separate existence.’”<sup>11</sup> However the issue does not appear to have been debated very much between the late 19<sup>th</sup> century and the early 1990s. In their report on Customs in April 2000, the Treasury Committee noted just two occasions during the century when the question of a merger arose:

[At the time of the] 1908 Budget ... it was announced that the Excise Department [then a separate department] would be transferred from the Inland Revenue to be merged with the Board of Customs. The then Prime Minister, H. H. Asquith, explained the change by saying that “from the point of view of administrative economy and efficiency I think — and my opinion is shared by almost all these distinguished Government officials who have had the closest experience of the inner workings of both offices — a substantial gain will result to the public service from that change”. Nevertheless, the Government was unwilling to state whether or not the change had been based on a rigorous analysis of the costs and benefits likely to result from it. An amendment to the Finance Bill to merge the revenue departments fully gained little support, and the modern day Customs and Excise department came into being on 1 April 1909.

The relationship between the Inland Revenue and Customs and Excise again became an issue with the introduction of VAT. Professor Sandford<sup>12</sup> told us that “there was not a reasoned debate about which department should operate [VAT], at the time the Inland Revenue was choked up with other reforms and therefore it went to Customs and Excise which had been doing purchase tax”. The Finance Act 1972 made explicit provision for the transfer of information between the two departments.<sup>13</sup>

The O’Donnell review noted that one of the reasons for pursuing a merger was “the experience of closer working between the departments since 1994, which had produced promising but limited results.”<sup>14</sup> The genesis of this programme lay in the ‘fundamental expenditure review’ set up by the Conservative Government in February 1993. As part of this review – looking at the expenditure of every department of state – the operations of the

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<sup>11</sup> *12<sup>th</sup> ICAEW Tax Faculty Hardman Memorial Lecture: Reforming Britain’s tax administration and policy-making*, 18 November 2004 p 4. The lecture may be downloaded from:

[http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I\\_73309,MNXI\\_73309&tb5=1&CFID=1669371&CFTOKEN=34255406](http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I_73309,MNXI_73309&tb5=1&CFID=1669371&CFTOKEN=34255406)

<sup>12</sup> [The late Professor Cedric Sandford, then Emeritus Professor of Political Economy at the University of Bath and a renowned expert on tax administration.]

<sup>13</sup> *Second report: HM Customs & Excise*, 8 February 2000 HC 53 1999-2000 para 13

<sup>14</sup> *Financing Britain’s future: review of the revenue departments*, Cm 6163 March 2004 p 7.

Revenue and Customs were examined, “to determine whether the current structure of the two departments with the tasks assigned between them on the present basis gives best value for money.” Though this review was not published, in November 1994 it was announced that one of the outcomes had been “not to merge the departments but for them to work together more closely.”<sup>15</sup>

In May 1999 the Treasury Committee conducted an enquiry into the Inland Revenue, and heard evidence on, among other issues, the experience of the closer working programme:

The UK is unusual in having a split tax administration in which VAT is administered with customs and excise duties. The Revenue and Customs and Excise (which is responsible for VAT, customs and excise) have embarked on a programme of closer working. This covers initiatives ranging from the STEPS estate management project to the five joint teams established to tackle the shadow economy and the co-ordinated case working pilots between the Revenue's Large Business Office and the Customs Large Trader Office.<sup>16</sup>

As it transpired, serious management failures in the first of these projects – the ‘STEPS’ procurement – were to lead to wider concerns in spring 2003 about the organisation of tax policy and administration; this is discussed below. Passing back to the Committee’s report, witnesses were critical of the ‘closer working approach’:

Mr Edward Troup<sup>17</sup> argued that “the common working and the close working at the bottom ... is bringing benefits, but I think the benefits that have been brought by that have probably been almost exhausted without further structural alignment because it is a separation of the actual management and operation of departments which I think is creating the problems and the obstacles in practice.” Mr John Whiting, of the Chartered Institute of Taxation and PricewaterhouseCoopers, agreed that “the best start, sitting in a merged firm, is to merge at the top and then start working down rather than just assuming that a bit of co-operation at the bottom will achieve what you want.”<sup>18</sup>

The Committee went on to note that the UK model – splitting tax administration between two departments – was followed in very few countries, and recommended that the Government carry out a feasibility study for a merger:

We do not feel able, on the strength of our evidence to date and before having examined the work of Customs and Excise, to recommend a merger between the Revenue and Customs. We expect to consider this question further when we inquire into Customs & Excise later this year ... However, we believe there is a

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<sup>15</sup> Inland Revenue Budget press notice IR49, 29 November 1994

<sup>16</sup> *Sixth report: Inland Revenue*, 25 May 1999 HC 199 1998-99 para 73

<sup>17</sup> Mr Troup was then head of tax strategy at Simmons & Simmons, though is now in the Treasury’s Budget and Public Finances Directorate (HM Treasury press notice 48/04, 17 May 2004).

<sup>18</sup> HC 199 1998-99 para 74



persuasive case for merger to be evaluated. And in view of the lead time it would take to plan and achieve a merger between the Revenue and Customs we see merit in actively considering now the feasibility and desirability of a merger in the long term ... We ... recommend that the Government commission a study to assess the feasibility of merging the two departments, the potential for savings in public expenditure and in compliance costs as a result of a merger, and an outline of how the merger might be planned.<sup>19</sup>

In its response to the report, the Government argued there would be no advantage in undertaking such a study. The possibility of a merger could not be ruled out indefinitely but “it is preferable to proceed with the programme of closer working which we have in hand.”<sup>20</sup> Details of this programme were given at the time; an extract is given below:

The departments are actively enhancing and extending CW [closer working] under the management of a steering group, led by Deputy Chairmen from each Department. Activity is focused through a small team under a Programme Director; the team is drawing up an action plan which will be finalised by September. This covers the following:

**policy**—where a joint policy steering group has been established to identify a programme of joint policy studies for the next Budget and beyond. An example of this is the continuing work on charities.

**compliance**—where on large businesses, the departments are currently working through eight joint case studies and evaluating the results. Additionally, they are considering their overall approach to these and identifying technical issues of common interest. For smaller businesses, they have a pilot involving five joint teams tackling the shadow economy, the results of which will be available in early September. They are also leading a pilot in the clothing sector, involving a wide range of public bodies looking at how they can encourage compliance and reduce burdens. Local offices are regularly exchanging information that helps them in delivering their local compliance work and the two departments are developing methods of communicating best practice across the country. They are looking centrally at how we measure the impact of our compliance work and at how they can share bulk data sets and intelligence to support compliance work.

**customer service**—where both departments are active in the setting up of the Small Business Service, led by DTI. They are continuing to develop joint initiatives aimed at providing integrated services where customers want them, for example in business start-up and in telephone and Internet services. They are leading an Invest to Save pilot to explore case-based reasoning technology to provide help and advice to small businesses, covering a wide range of regulatory procedures. On the ground, business advice and support teams participate jointly in "open days", seminars and advice surgeries for businesses and the two

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<sup>19</sup> HC 199 1998-99 paras 80-1

<sup>20</sup> Treasury Committee, *Sixth special report*, 20 July 1999 HC 746 1998-99 p xi

departments are planning to widen the role of business support teams in the Revenue to include Customs staff.

**support services**—where a number of central services are being reviewed to examine the scope for efficiencies including estates, procurement and training. The two departments are participating jointly also in the BQS programme where it makes sense to do so.<sup>21</sup>

In the Government's view, the fact that other countries had different administrative systems was not, in itself, a sufficient case for merger:

As the Committee's report has shown, different countries differ in the way in which they organise themselves to handle the direct and indirect taxes. There is no right model, and it is up to each administration to develop the arrangement which suits it best. So far as the United Kingdom is concerned, the Government has concluded that, certainly for the time being, in view of the inevitably substantial costs that merger would entail, it would be better to retain the existing separate organisations, while pursuing vigorously the advantages which closer working can undoubtedly bring.<sup>22</sup>

On this question, it is worth noting that in his lecture to the ICAEW cited above, Gus O'Donnell referred to certain international trends which had suggested that merging the UK's revenue departments would be a sensible way forward:

History teaches us that tax systems accumulate over time in ways not shaped by an overall design perspective. Economic and social structures will change and the objectives of one administration may be different from its predecessors. So I personally came to the review with an open mind and a feeling that there would undoubtedly be some aspects of the existing system that were one to start from scratch, would not have been structured in the way they were.

In particular I was struck by some of the overlap of functions between the two departments, and also by the trend internationally which has seen a move away from the separation of the collection of direct and indirect taxes. In Canada and Australia, both of which I visited, the integration of these functions is seen as virtually an unqualified success. Prior to the review, the UK sat alone with Israel and Malawi in keeping direct and indirect tax collection separate. Just after the Budget announcement, my counterpart from Tel Aviv came to see me to tell me that the Israelis were following suit. Interestingly, both the IMF and OECD advise against dividing the functions.<sup>23</sup>

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<sup>21</sup> HC 746 1998-99 pp x-xi

<sup>22</sup> HC 746 1998-99 p xi

<sup>23</sup> *12<sup>th</sup> ICAEW Tax Faculty Hardman Memorial Lecture*, 18 November 2004 p 4

## B. The Treasury Committee's recommendation for a merger

In April 2000 the Treasury Committee produced a report on Customs, arguing that a merger of the two authorities “would improve compliance with taxation, reduce businesses’ compliance costs and reduce the Government’s revenue collection costs.”<sup>24</sup> The Committee were strongly critical of the closer working programme, although they agreed “wholeheartedly” with its aims: “Although we acknowledge that the programme appears to have delivered some benefits, particularly in terms of more coordinated policy making, we are not convinced that the programme as a whole is sufficiently well designed or managed to achieve its aims.”<sup>25</sup>

Among the Committee’s concerns were “the slow pace” at which the programme had developed since 1994, the lack of any “general philosophy or rationale underpinning” those areas chosen for closer working, and the absence of a “full evaluation” of its effectiveness. Indeed witnesses to the Committee “could cite few specific benefits to businesses which had resulted from the ... programme” since its inception.<sup>26</sup>

The Committee’s overall assessment of closer working, in their view, made the option of a merger worthy of “serious consideration”:

Customs and Excise has been able to point us towards few if any tangible results or benefits of Closer Working, which seems as vague a concept at the end of this inquiry as it did at the beginning. In its evidence, the department has not convinced us that Closer Working would be a central theme of the department's future development, for instance by emphasising that the potential for economies of scale in working jointly with the Inland Revenue were “across a fairly narrow field” and by indicating that Closer Working projects in the procurement and information technology areas would be subsumed by pan-Government initiatives ... We do not believe that the Closer Working programme will fully achieve its objectives and deliver the benefits claimed by Customs and Excise. Consequently, the option of merger requires serious consideration.<sup>27</sup>

Witnesses to the Committee provided a variety of views on the benefits of merger and the likely costs, although there was consensus that if it were proceeded with, the *timing* would be crucial – “particularly as the Inland Revenue is currently digesting the Contributions Agency.”<sup>28</sup> In his March 1998 Budget the Chancellor had announced a series of changes to National Insurance, as part of the Government’s aim “to create a modern tax system that will help create jobs and reward work.” One of these measures was the “establishment of a single organisation to deal with both income tax and National

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<sup>24</sup> *Second report: HM Customs & Excise*, 8 February 2000 HC 53 1999-2000 para 45

<sup>25</sup> HC 53 1999-2000 para 34

<sup>26</sup> HC 53 1999-2000 paras 25, 26, 32, 27

<sup>27</sup> HC 53 1999-2000 para 34

<sup>28</sup> HC 53 1999-2000 para 37

Insurance.”<sup>29</sup> At the time responsibility for National Insurance contributions (NICs) and the administration of both statutory sick pay and statutory maternity pay lay with the Contributions Agency (CA) – an Executive Agency of the then Department for Social Security. The *Social Security Contributions (Transfer of Functions etc.) Act 1999* transferred the Agency to the Inland Revenue with effect from 1 April 1999.<sup>30</sup> It was the Committee’s view that “an opportunity for merger exists after the Contributions Agency has been fully integrated into the Inland Revenue.”<sup>31</sup>

In coming to their conclusion the Committee were particularly impressed by the experience of the Canadian authorities. This is also a theme in the O’Donnell review, which discusses the integration of its two revenue departments at some length:<sup>32</sup>

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

In designing the new organisation, the Canadians adopted what they described as a ‘hybrid functional program’ model, integrating all support functions, creating a single regional network but maintaining a separation between traditional Customs frontier and trade work on the one hand, and tax administration on the other (until customs was transferred to the border agency in 2003) ...

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

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

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<sup>29</sup> HC Deb 17 March 1998 cc 1103-1104

<sup>30</sup> The background to this measure is examined in *Social Security Contributions (Transfer of Functions etc.) Bill [HL]*, Library Research paper 99/12, 5 February 1999.

<sup>31</sup> HC 53 1999-2000 para 43

<sup>32</sup> The review cites just one study of the Canadian merger in its discussion of its impact: Baker, W. *Organizational Aspects and Human Resources Problems in an Integrated Organization*, Lecture for the CIAT Technical Conference, Madrid 1997.

The two aims of an integrated audit were to improve audit coverage, and reduce the levels of intrusion for taxpayers. In practice, implementation was difficult ..., but now the approach is well embedded the CRA have seen significant productivity gains and believe the main gain has been the reduction in compliance costs for small business.<sup>33</sup> The Canadian Taxpayers' Federation, the watchdog for small businesses and independent taxpayers, has been pleased with the simplification of customer interactions and their initial concerns about taxpayer privacy in relation to data mining and offsets have now abated. The Large Business Advisory Committee has also given positive feedback on the changes. Overall, the Canadian government and international organisations consider the integration to have been a success.<sup>34</sup>

One practitioner writing on the O'Donnell review was critical of this comparison: "much is made in the report of the changes introduced overseas and the way tax authorities have improved following merger. Little is said, however, of the countries that were examined that have had a single tax authority for many years, which are less efficient (for instance France) and how these examples demonstrate a case for merger (or not)."<sup>35</sup>

In their report in April 2000 the Treasury Committee acknowledged that quantifying the benefits of merger was "difficult" because these might include "unexpected synergies across the whole range of the tax authorities' activities which might be difficult to predict in advance." Even so, it was confident of certain improvements, with "synergistic improvements in compliance, collection costs and the new department's revenue collection culture."<sup>36</sup> In Gus O'Donnell's view one of the key benefits from the merger will be seen in lower compliance costs, especially for businesses:

As businesses are often customers of both departments (the overlap is somewhere in the region of one million companies), they potentially have most to gain in terms of reduced compliance costs from a more joined up approach. The importance of this becomes even clearer when you consider that these one million companies contribute just over one fifth of the direct tax yield, three quarters of the yield from VAT and they administer a large proportion of total income tax, national insurance contributions and tax credit payments for their employees. Hence there is a real opportunity to reduce compliance costs, taking an overview of the services provided to customers and developing a whole customer view – for example with a joined up approach for audit visits for direct and indirect taxes.<sup>37</sup>

At the time the Government rejected the Committee's recommendation, arguing that the benefits of a merger could be achieved, avoiding its costs, "through a dynamic and

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<sup>33</sup> Baker, W., *Lecture for the CIAT Technical Conference*, Madrid 1997

<sup>34</sup> Cm 6163 March 2004 p 61

<sup>35</sup> "The future of tax", *Tax Journal*, 19 April 2004 p 9

<sup>36</sup> HC 53 1999-2000 paras 44-45

<sup>37</sup> 12<sup>th</sup> ICAEW Tax Faculty Hardman Memorial Lecture, 18 November 2004 p 5

focused programme of closer working [between the two departments].”<sup>38</sup> In a letter to the Committee the Paymaster General, Dawn Primarolo, underlined the risks inherent in such a move:

It needs to be recognised ... that there are also important differences between the roles of the two Departments, which require the development of different skill sets in terms of assurance and collection. Indirect taxes are transaction-based taxes, requiring real-time identification of transactions with near-simultaneous and continuous collection. Direct taxes are periodic and accounts-based, generally collected in arrears. Indirect taxes (VAT and customs especially, and to a lesser extent, excise) are governed by EU law, and customs work is international. Indirect taxes and prohibitions of goods, both historically and by their nature, are also more open to fraud and criminality—which brings customs and excise work more closely into the realm of law enforcement. Even within a single “revenue department”, different skill sets would need to be developed and maintained—as a management task, a merger would not be a simple matter of harvesting synergies.

These specific management issues have to be weighed in the context of the wider implications of a merger. Any merger, in private and public sector, entails large actual “up-front” costs and risks to current process as well as major opportunity costs, as managers divert effort into organisational rather than business-focused activity. These are large, complex, and, as noted above, by no means homogenous organisations and we judge these risks to be large in relation to the potential benefits above and beyond those which effective closer working could deliver.<sup>39</sup>

### **C. The Revenue/Customs STEPS PFI project**

As noted above, one of the elements of the closer working programme between the Revenue and Customs was the ‘STEPS’ joint procurement project, first announced in August 1998.<sup>40</sup> The aim of the project was to transfer the ownership and management of the departments’ respective estates to a private sector partner. The successful bidder would supply both departments with overall building management, maintenance, cleaning and waste management services. The procurement process was begun in March 1999<sup>41</sup> and in August 2000 Mapeley Limited was announced as the preferred tenderer.<sup>42</sup> A contract was agreed in March 2001.<sup>43</sup> At the time both the Revenue and Customs stated that the company was registered in the UK. In fact Mapeley was registered in Bermuda, an error the Revenue only publicised in September 2002.<sup>44</sup>

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<sup>38</sup> Treasury Select Committee, *Second special report*, 18 April 2000 HC 442 1999-2000 p v

<sup>39</sup> HC 442 1999-2000 p iii

<sup>40</sup> Inland Revenue press notice 119/98, 19 August 1998

<sup>41</sup> Inland Revenue and HM Customs & Excise press notice JW 7, 30 March 1999

<sup>42</sup> Inland Revenue and HM Customs & Excise press notice JW7, 3 August 2000

<sup>43</sup> HC Deb 22 March 2001 c 360W

<sup>44</sup> “Revenue admission on £220m deal in tax haven”, *Financial Times*, 24 September 2002

The Paymaster General summarised these developments in a written answer in October 2002, part of which is reproduced below:

**Dawn Primarolo:** The Inland Revenue and Customs and Excise "STEPS" competition was announced in August 1998. The two Departments' contract with the Mapeley consortium was signed on 6 March 2001 after a full procurement exercise.

A joint Inland Revenue and Customs and Excise press release dated 9 March 2001 inadvertently referred to assets being transferred to Mapeley Ltd, a UK registered company, rather than Mapeley STEPS Ltd which is registered in Bermuda. Subsequently, a separate press statement has corrected this. Ministers were not aware of the registration of Mapeley STEPS Ltd at the time of the March 2001 press notice.

The STEPS contract with the Mapeley consortium provided for the payment of £220 million to the Departments together with a further £150 million to be reflected in lower service prices. Details of the rival bids are, as is customary, commercially confidential. However, the competition to establish which bidder offered best value for money included rigorous examination of all factors relevant under the appropriate UK and European rules. By convention, the tax affairs of individual companies are not disclosed to Ministers. No separate assessment has been made of the effect of the tax status of Mapeley STEPS Ltd.<sup>45</sup>

As the Treasury Committee observed – in a report on STEPS published in February 2003 – although the structure Mapeley had erected for this contract was not ‘tax avoidance’ as such, “on the basis of Mapeley’s own evidence to the Committee it had ‘structured its tax affairs to minimise exposure to Capital Gains Tax’ [and] tax avoidance was clearly one of Mapeley’s objectives in the way the deal was structured”:

We accept both that Mapeley was entitled to minimise its tax liabilities and the evidence that the avoidance of tax in this case was legal. However, we consider that the Inland Revenue, responsible for implementing the Government’s policy of reducing tax avoidance, should of all departments have been alert to the difficulties of being party to a deal that transferred ownership of its properties to an offshore company. We are concerned that these difficulties were not recognised at the time. We regard the fact that the project team did not explore with Mapeley the possibility of an alternative structure to the deal that might have avoided them as a failure in the way the project was handled.<sup>46</sup>

Of wider significance, the Committee found that Revenue officials had failed to keep either the Inland Revenue Board or Ministers properly informed during the progress of the project:

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<sup>45</sup> HC Deb 15 October 2002 cc 596-7W

<sup>46</sup> *Fourth report: The handling of the joint Inland Revenue/Customs and Excise STEPS PFI project*, 12 February 2003 HC 184 2002-03 paras 15-16

The Board of the Inland Revenue was not informed by the project team that, under the contract, the Revenue's properties would be transferred to a company registered in Bermuda. The Board appears to have discovered this fact a few days before the contract was due to be signed only because one of its members, knowing that arrangements of this sort were common, asked what the structure of the Mapeley companies was. The Customs and Excise Management Committee and the relevant Minister, the Paymaster General, were not told of the offshore structure of the contract before it was signed.

We reject the proposition put forward by the Chairman of the Inland Revenue that at worst the charge against the project team is one of naivety, a view we believe is complacent. We view with great concern the fact that such failures in briefing senior management and the Minister have occurred. We expect the Departments to have identified exactly where and how things went so seriously wrong and to have taken the necessary steps to prevent a recurrence.<sup>47</sup>

Similar failures to inform the Board or Ministers occurred when, as a response to Mapeley's worsening financial position, Revenue officials sent 'letters of comfort' to Mapeley in May and June 2002 – to be shared with their auditors, bankers and shareholders, explaining how a future settlement over the deal might be achieved.<sup>48</sup> In the light of these failures the Committee recommended that “a review be undertaken of the relationship between Treasury Ministers and the bodies for which they are accountable to ensure appropriate standards of governance and accountability are met.”<sup>49</sup>

For the purposes of its report the Committee confined itself to considering the way the STEPS project was handled administratively by the Departments. A value for money study on the project carried out by the National Audit Office and published in May 2004 found that the deal “has delivered benefits and more are expected”, that “the Departments got a good price”, and that “good risk management will be essential.”<sup>50</sup>

The Government published its response to the Committee's report in May 2003, acknowledging that “experience with the Mapeley project has clearly illustrated failings in the Departments' internal procedures.” On the question of a review it was confirmed that “the Chancellor of the Exchequer has asked the Permanent Secretary to the Treasury, in consultation with other Heads of Departments, to advise him on any clarification and improvements that may be required.”<sup>51</sup> As it transpired, this work was incorporated in the O'Donnell review which the Chancellor set up in July 2003.<sup>52</sup>

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<sup>47</sup> HC 184 2002-03 para 25

<sup>48</sup> HC 184 2002-03 para 47

<sup>49</sup> HC 184 2002-03 para 48

<sup>50</sup> NAO, *PFI: the STEPS deal*, 7 May 2004 HC 530 2003-04 p 2

<sup>51</sup> Treasury Select Committee, *Fifth special report*, 19 May 2003 HC 706 2002-03 pp 5-6

<sup>52</sup> HM Treasury press notice 78/03, 2 July 2003



The Committee reiterated its concerns about the relationship between the department and the Treasury in a report in July 2003,<sup>53</sup> in the context of the Revenue's failure to send out 'deficiency notices' for National Insurance records. Under a system set up in 1981 individuals with gaps in their contribution records would receive notification 18 months after the end of the relevant tax year.<sup>54</sup> In 1998 the Contributions Agency suspended deficiency notices because of problems with the NIRS2 computer system. This meant that people with deficient records from 1996/97 onwards were not notified of the fact. It was not until 2003 that the Inland Revenue took action to re-introduce the system.<sup>55</sup>

The Committee's report followed the announcement of the O'Donnell review, which it acknowledged in its conclusions:

Senior managers waited several months before informing the responsible minister of the problems regarding the suspension of deficiency notices. This is a further example in a growing list of failures of communication between ministers and officials and reinforces our previous calls for action to be taken to ensure appropriate standards of governance and accountability are met. We therefore welcome the announcement of a fundamental review of the revenue departments that will specifically look at a new framework for accountability for those working on tax, to set out more clearly the roles and responsibilities of all those involved, including ministers.<sup>56</sup>

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<sup>53</sup> *Tenth report: Inland Revenue matters*, 23 July 2003 HC 834 2002-03

<sup>54</sup> Inland Revenue press release, *Extended time limits for paying voluntary contributions*, 5 April 2003

<sup>55</sup> Further background to this issue is given in "Pension contribution conditions", Library standard note SN/BT/3111, 25 June 2004.

<sup>56</sup> HC 834 2002-03 para 65

## II The O'Donnell review

In July 2001 the Treasury Committee established a Sub-Committee to scrutinise the work of the various bodies for which Treasury Ministers are accountable. On 2 July 2003 the Paymaster General, Dawn Primarolo, gave a statement to the Sub-Committee – when giving evidence on Inland Revenue matters – announcing a review of the revenue departments:

**Q208 ... Dawn Primarolo:** Chairman, I can today tell the Committee that the Chancellor is announcing a major review of our organisations dealing with tax policy and administration. The review will report to Treasury Ministers and be chaired by Gus O'Donnell, Permanent Secretary to the Treasury, working closely with the Revenue departments and their Chairmen. The Chancellor is asking that the work be completed in time to announce initial conclusions and any next steps in this year's Pre-Budget Report. The remit for the review is to examine the best organisational arrangements for delivering the Government's tax objectives both now and into the future. The review will also consider the case for changes in the law where necessary to allow the full benefits of particular arrangements to be realised and pay particular attention to the need to ensure the continued effectiveness of the core business of revenue collection and administration.

In her statement to the Committee the Paymaster General went on to set out the terms of the review in detail:

Specific points the review will cover include: ways to enhance service delivery to taxpayers and how these are most effectively ensured. Inland Revenue and Customs and Excise together deliver some of the most important functions for the Government, for the public, and for the business community. They have a very large number of customers in common. The review will have a particular remit to examine whether, through closer working between the Revenue departments or through organisational change, costs to honest taxpayers and compliance costs to businesses can be reduced.

Secondly, the coherence of administrative systems, including information and efficient use of resources across the broad area of tax administration taking into account future technological development which will open up new avenues for enhanced services. Thirdly, how best to ensure consistent and effective enforcement of the law against those who do not pay their fair share, particularly those who make a business out of cheating the tax system. As part of this review we will examine work being done separately by the Government on the links between tax organisations and the law enforcement agencies. Fourthly, the most appropriate structure for delivering policy advice to Ministers. Currently officials working on strategic tax policy questions are spread across three departments. A more co-ordinated approach to fiscal policy advice is desirable, and the review will look at how we can best create a focus for tax policy work.

Fifthly, a new framework for accountability for those working on tax, to set out more clearly the roles and responsibilities of all those involved. Greater clarity will provide better certainty both for officials and Ministers. The review currently

being conducted by Gus O'Donnell which was announced in the Government's response to the Fourth Report 2003 of the Treasury Select Committee will form part of this work.

The primary focus of the review will be making public service delivery more effective and efficient. The review will be conducted in discussion with the unions and other stakeholders. Since 1997, Inland Revenue and Her Majesty's Customs and Excise have worked effectively with the Treasury to play a key role in support of this Government's reforming agenda. Their record is one of success and a tribute to the staff of the Revenue departments and to their chairmen, Sir Nicholas and Sir Richard. The Revenue departments do a first rate job and this review is intended to build on their success to ensure that we make the best use of the resources that we have.<sup>57</sup>

The Chairman, Michael Fallon, asked why the Government felt the review was necessary:

**Q209 Chairman:** Thank you very much. If the Revenue departments were doing a first rate job we would not need an organisational review, would we?

**Dawn Primarolo:** I think as we have discussed in the Select Committee at different times over the years the Revenue and Customs, but particularly Revenue, have taken on additional responsibilities: the Contribution Agency, Tax Credits now. It is important at this stage, particularly now that these policies are established, and the Chancellor believed appropriate, that we should take a wider look at the current and future Government objectives for the tax regime and examine how best they can be achieved, and therefore this is the appropriate time in order to do that, particularly bearing in mind the response the Government made to this Select Committee on the question of a review of departments.

I think what is important is that we have tax departments that are some hundreds of years old in terms of their functions and have served governments, all governments, over that period of time extremely well. Those departments have their own devolved responsibilities through care and management and responsibilities to Ministers. As that role continues to develop, it is an appropriate time to take stock and to consider whether further achievements can be made. I think that in looking back over the years at the work of this Committee in suggesting such activities, the appropriateness now of taking such a step is very important. Of course, the Chancellor is making clear that the initial conclusions from that need to be available in time for the Pre-Budget Report to determine what, if any, further steps should be taken.<sup>58</sup>

On the same day the Chancellor confirmed that Mr O'Donnell would chair the review; a press notice set out the specific points it would cover.<sup>59</sup>

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<sup>57</sup> Treasury Committee, *Tenth report: Inland Revenue matters*, 23 July 2003 HC 834 2002-03 Ev21-22

<sup>58</sup> HC 834 2002-03 Ev22

<sup>59</sup> HM Treasury press notice 78/03, 2 July 2003. Details of the review were also given in a written answer at this time: HC Deb 2 July 2003 cc 270-1W.

The Treasury Committee's final report did not discuss the Minister's statement at length, but in its conclusions it referred to the recommendation its predecessors had made for a Customs-Revenue merger:

In a report on Customs and Excise in February 2000, our predecessors concluded that the merger of the Inland Revenue and Customs and Excise "would improve compliance with taxation, reduce businesses' compliance costs and reduce the Government's revenue collection costs." The report recommended "that such a merger should proceed." We welcome the fact that this will now be explored as part of the review announced by the Chancellor into the best organisational arrangements for delivering the Government's tax objectives, and we intend to follow the progress of this review closely.<sup>60</sup>

The possibility that the review might lead to a merger was raised at the time.<sup>61</sup> Later that year speculation about a merger was heightened following a critical report by the National Audit Office<sup>62</sup> into the Revenue's administration of tax credits.<sup>63</sup>

Some commentators raised a concern about tax policy: John Battersby, head of tax strategy at KPMG was quoted as saying, "the worry is that if the Treasury is in sole charge of tax policy, it will rely less on the Revenue and Customs officials, who have generally had the contacts with taxpayers. For Ministers to reduce that input would not be helpful."<sup>64</sup> Gus O'Donnell provided some insight on the current arrangements regarding tax policy in his ICAEW lecture in November 2004:

The roles of the Treasury and the revenue departments have been ill defined for decades. Even a man as talented as Lord Bridges, Permanent Secretary at the Treasury from 1945 to 1956 struggled to sum up the relationship. Here was his attempt in 1963: "The Inland Revenue and HM Customs and Excise are responsible to the Chancellor, and are subject to a measure of Treasury direction. This however means Ministerial direction. The officials of Revenue and Customs do not take orders from Treasury officials. But in framing taxation policy the Treasury shares with the Revenue Departments responsibility for advising the Chancellor. The Treasury is also usually concerned in any matter where taxation principles or policy have a bearing on or are affected by some aspect of Government policy."

In general the revenue departments have historically led on policy development for individual taxes and on the care and management of the tax system, submitting advice directly to Ministers. However, policy advice tended to be by

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<sup>60</sup> HC 834 2002-03 p 21

<sup>61</sup> "Review may force Inland Revenue to merge with Customs", *Financial Times*, 3 July 2003

<sup>62</sup> *Inland Revenue: Standard Report 2002-2003 – Tax Credits*, 19 November 2003 HC 1072 2002-2003

<sup>63</sup> "Blunders leave dents in model of virtue", *Financial Times*, 20 November 2003; "Tax review expected to dish up fresh taste", *Financial Times*, 25 November 2003

<sup>64</sup> "Treasury may get 'too much power' in tax review", *Financial Times*, 4 July 2003. See also, "Governance fears as tax bodies move in together", *Daily Telegraph*, 8 July 2003.

tax type, rather than looking at the sectoral implications of tax as a whole, for example, the effect of a range of different measures on small business. The Treasury has tried to do these kinds of analysis but has never had the sufficient expertise to do them in much depth. In all of this it is the tax policy function of the Treasury that is the most striking anomaly.<sup>65</sup>

When the review was set up it was announced that “the Chancellor will set out initial conclusions and any next steps in this year’s Pre-Budget Report.”<sup>66</sup> In the event the *Pre-Budget Report* in December 2003 simply stated that the review “has made good progress and will report very soon.”<sup>67</sup> This issue was raised by Michael Fallon, chairman of the Treasury Sub-Committee when Mr O’Donnell gave evidence to it in April 2004:

**Q3 Chairman:** ... You implied there would be a document to consult at the time of the PBR but in fact you simply published your conclusions.

**Mr O’Donnell:** The general view of the Chancellor as I discussed this with him was it would be better for all concerned if we made it clear that there was a strategic decision by Government that this is the way they wanted to go and there would be consultation about the way in which we implemented that strategic conclusion.<sup>68</sup>

Mr Fallon went on to ask Mr O’Donnell why the Government had changed its mind on merging the revenue departments, observing that “we recommended it back in April 2000 but you turned it down ... why now?”:

**Mr O’Donnell:** In 2000 what we did was start a process of closer working between the Departments, this started back in 1994 and it was extended in 2000. The experience of having closer working, particularly things like Joint Shadow Economy Teams, JoSETs as they are known, was they produced good benefits but they were in very limited areas. The closer working was because we were taking people from Revenue and Customs and getting them involved in joint projects that was fine but the department still had their own priorities and their own objectives. In order to make this bigger across the board it was quite clear to all of us in Treasury, Revenue and Customs that closer working whilst producing good results was not going to produce the really big benefits which you could get from a more radical change. At the same time we were having other machinery of Government changes, like DWP coming into existence, which taught us about a lot about merging organisations in the public sector. In general with the increasing strategic focus on delivery and efficiency that has led us to a situation where we have thought again.<sup>69</sup>

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<sup>65</sup> 12<sup>th</sup> ICAEW Tax Faculty Hardman Memorial Lecture, 18 November 2004 p 7

<sup>66</sup> HM Treasury press notice 78/03, 2 July 2003

<sup>67</sup> Cm 6042 December 2003 para 5.87

<sup>68</sup> *Ninth report: the merger of Customs & Excise and the Inland Revenue*, 3 November 2004 HC 556 2003-04 Ev 1

<sup>69</sup> HC 556 2003-04 Ev 2

### III Budget 2004

#### A. The outcome of the O'Donnell review

In his Budget statement on 17 March 2004 the Chancellor announced the Government's response to the report of the O'Donnell review:<sup>70</sup>

Because it is ... our duty when we consider public investment to do everything to secure value for money, last year the Prime Minister and I decided to review the future of the Inland Revenue and Customs ... We are ... announcing that as a result of the O'Donnell review, we will merge Her Majesty's Customs and Excise and the Inland Revenue. Whereas in the past business had to deal both with the Revenue and Customs, business will now deal with a single tax service, which, because of the investments we have made in the new technology, can make large savings in back office costs.

While improving front office services, I have decided in the spending review on a budget reduction by 2008 of in excess of 5 per cent. in real terms. The Inland Revenue and Customs and Excise are announcing today a gross reduction of 14,000 staff posts, a redeployment of three and a half thousand, and thus an overall reduction by 2008 of ten and a half thousand staff posts.<sup>71</sup>

The case for a merger was summarised in *Budget 2004*: "The creation of a single, customer-focused, department, which makes better use of the information that taxpayers provide, will improve tax collection from the non-compliant and reduce costs for the compliant, helping to improve the fairness of the tax system."<sup>72</sup>

The review is a substantial document and it would be infeasible to discuss it at great length. For convenience a two page summary of its contents is reproduced below, taken from the regulatory impact assessment (RIA) of the *Commissioners for Revenue and Customs Bill*.<sup>73</sup>

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<sup>70</sup> *Review of Revenue Departments* Cm 6163 March 2004 – hereafter referred to as *O'Donnell*.

<sup>71</sup> HC Deb 17 March 2004 c 331

<sup>72</sup> HC 301 March 2004 para 5.80

<sup>73</sup> *RIA: the Commissioners for Revenue and Customs Bill*, November 2004 pp 22-23

### Summary and recommendations of the Review of the Revenue Departments

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

The analysis is focussed on three leading options:

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

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

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

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

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

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

The review therefore recommends that:

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

### **Summary and recommendations (continued)**

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

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

In May the Government announced that the new department would be called Her Majesty's Revenue and Customs, and its first executive chairman would be David Varney, outgoing chairman of MMO<sub>2</sub> and chairman of Business in the Community.<sup>74</sup> The *Financial Times* reported that, "business organisations and the accountancy profession welcomed the appointment and said having a single department would greatly simplify the payment of taxes and duties."<sup>75</sup>

In an interview in July Mr Varney suggested that the biggest challenge posed by the merger was "fostering a new culture". The article quoted him as saying:

"The main challenge is to create a culture of people who believe that this is do-able and something they can deliver.. I would like to feel that at the end of three years we had made enough progress that there was confidence that HM Revenue and Customs had delivered what was expected of it in terms of its

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<sup>74</sup> Inland Revenue press notice 47/04, 13 May 2004

<sup>75</sup> "MMO<sub>2</sub> chief to head merged Revenue", *Financial Times*, 14 May 2004



progress to being a single authority, had got a productive relationship with the Treasury and had met the requirements imposed on it by ministers. That would be my scorecard.”<sup>76</sup>

Mr Varney had been one of three ‘external examiners’ who had given the O’Donnell review their views on whether a merger was a practical proposition – “senior figures from the private sector with relevant experience” as *O’Donnell* explains – prior to the final publication of its report.<sup>77</sup> Mr Varney’s conclusions as presented to the review are reproduced in full below.<sup>78</sup>

#### **O’Donnell review: External Examination – views of David Varney**

*I am pleased to have the opportunity to contribute to your review of Customs and Excise, the Inland Revenue and Treasury. I bring general commercial expertise rather than specific knowledge of the Inland Revenue and Customs and Excise.*

*The thrust of your conclusions is sensible. There is a good case for a single department dealing with tax administration. International trends support integration, particularly to ensure that VAT is administered as an integrated part of a business tax system and the potential effectiveness benefits are harvested. In my experience inter organisational co-operation has limited benefits and these are primarily at the margins of the organisations concerned rather than at their hearts. In situations like this where there are potential benefits from more intense linkages it makes sense to reflect those in structures.*

*The emphasis on greater customer focus and service is welcome and in my view right. When they are successful, businesses understand the value of deep and rich customer knowledge, and work hard to acquire and use that knowledge. At MMO<sub>2</sub>, we have improved our performance by using more sophisticated customer segmentation. Customer focus is not easy, and does not happen by accident: the aims for the organisation must be reflected in the mission and structure of the organisation itself.*

*Government is increasingly internalising the same lesson, and building the customer or citizen into the heart of public service delivery. This is a good thing, and your review is an opportunity to take a further step along this road in a very important area. As your report makes clear, there is a great deal of expertise and energy within the two departments, which when harnessed could be a formidable force. I also believe that business know-how can help Customs and Excise and the Inland Revenue to rise to their challenges, and hope that a new department would look both inwards and outwards when shaping its future.*

<sup>76</sup> “Tying the knot is a culture challenge”, *Financial Times*, 9 July 2004

<sup>77</sup> Full details of this process and the views of the three individuals concerned are set out in Annex D of *O’Donnell* (pp 161-6).

<sup>78</sup> *O’Donnell* pp 165-6

**O'Donnell review: – views of David Varney (continued)**

*None of this means that creating a single department will be easy. It is quite clear it will be a tremendous challenge, for everyone involved. That includes the staff, who will have to balance the demands of the on-going work with the uncertainty of change. But it also includes Ministers, who will have to find a new way of working with the Department, and customers, who will have to help the new body develop its services and approach. It will be a challenge to keep a long-term focus on the effectiveness prizes and not fall prey to the temptation to substitute short term cost reduction objectives.*

*In the oil business, a project like integrating the two departments would be referred to as “brownfield engineering”. You do not have the luxury of a blank sheet, but work with an extensive set of existing processes and infrastructures. This makes planning difficult, though not impossible. Outside perspectives are useful, but planning has to be done with a heavy dose of familiarity with existing structures. As a result, I believe your report should set out desirable outcomes, but cannot attempt to set out how they could best be achieved.*

*That said, you might want to recognise in the report that the process of establishing a single new department would not and should not be quick. Although doubtless some action could and should be taken fast, other areas, such as development of new services for small companies, would have to be taken forward in consultation with the customers and at a pace that ensures they can be piloted and rolled out in a way that builds confidence. Integration of the two departments and the creation of a new identity will also involve costs, at least in the short term. These should be worked out at the early stages of business planning.*

*In terms of senior structure, in steady state my suggestion would for a single leader for the Department who also discharges the accounting officer role. I would suggest in the transition, when there will be particular strains on the senior team you need to seriously consider more full time resources in the leadership to deliver this change programme. As with service planning, I would advise against attempting to specify in your work the composition of the Board, perhaps limiting yourself to defining overall size and certain key roles (such as finance director). Flexibility is powerful: you need a team able to adapt to particular challenges it faces.*

*If a single department is established, it would have huge risk management task – risk relating to revenue streams as well as IT projects. An absolute requirement for the new organisation will be good processes to deal with those risks – particularly on IT. I suspect that the material on information you have gathered may conceal a very complex pattern of data. Developing this into something coherent for the new department would be a very intensive exercise.*

*I hope these thoughts are helpful. The project is clearly an important and valuable one. I believe it has potential to pay real dividends for the people working in the departments and its customers - to achieve this will require both delivery of the current business imperatives and managing the change process to deliver the effectiveness gains.*

## B. Reactions to the proposed merger

In his response to the Chancellor's 2004 Budget speech the Leader of the Opposition, Michael Howard, said, "There are, of course, some things in the Budget that we welcome ... We ... welcome the potential savings that could arise from merging the Inland Revenue with Customs and Excise, but can the Chancellor guarantee that there will be no political interference in the enforcement of tax law? After the debacle that followed the transfer of responsibility for tax credits to the Inland Revenue, can he assure us that disruption on a similar scale is not likely to happen again?"<sup>79</sup> Notably *O'Donnell* refers to the introduction of tax credits as paving the way to its own work:

The Government has made significant changes to the tax and benefit system, in particular the introduction of tax credits in 1999. These changes were the Government's first priority. Having dealt with these changes, and having given closer working between the revenue departments a chance to deliver, now is the time to consider the best structures and accountability for tax policy and administration, as well as the role of information in supporting them.<sup>80</sup>

There have been a number of problems in the administration of tax credits, as the National Audit Office reported in October 2004:

The new Tax Credits have proved relatively easy for people to access but many have found it difficult to understand exactly how much they are due - a problem made worse for those who have been paid the wrong amounts. The administration of the new Tax Credits has proved complex in parts, reflecting the underlying design of the new Tax Credits and the desire to provide support that is responsive and tailored to a wide range of circumstances ...

Some essential controls over the new Tax Credits did not work in 2003-04, including the daily reconciliation of payments authorised with payments made, which was planned as a fundamental daily check on processing ... The Department had to move staff from other tax work to help when the new Tax Credits system problems arose in the first half of 2003-04. It plans to recover fully from the impact of the initial Tax Credits problems by the end of 2004-05. It will need to ensure that the recovery plans are not frustrated by further extensions of the new Tax Credit IT systems. Business as usual collecting taxes must not be allowed to suffer and the Department must ensure that their responses to system problems do not undermine their reputation for integrity of processing taxpayers' affairs.<sup>81</sup>

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<sup>79</sup> HC Deb 17 March 2004 c 338

<sup>80</sup> *O'Donnell* para 1.12

<sup>81</sup> *Inland Revenue: Standard Report 2003-2004 – Child and Working Tax Credits and Stamp Duty Land Tax*, 21 October 2004 HC 1062 2003-2004 p 113. For more details see, "Tax credits: annual assessments, changes in circumstances and overpayments", Library standard note SN/SP/3205, 22 October 2004.

In November 2004 the Treasury Committee published its report on the proposed merger.<sup>82</sup> Several witnesses to the Committee expressed concerns about the risks posed to tax collection and the level of service provided to taxpayers. When Gus O'Donnell gave evidence Nigel Beard noted the Revenue's difficulties with tax credits and asked, "what assurances can you give this Committee that we will not be sitting here in twelve month's time listening to a story of disrupted tax collection and poor service for the taxpayer arising out of this merger?"<sup>83</sup> In his response Mr O'Donnell underlined that ensuring 'business as usual' for projects such as tax credit renewal would be a priority for HMRC:

If you think about IT and Government, who was first in getting into IT and delivering public services through the internet, it was the Inland Revenue ... When you are first you are obviously going to face some of the risks of being first and it is certainly true that there were problems with Tax Credits. The Department is very keen to learn the lessons of those and we are looking at Tax Credit renewals now and that is being managed ... I think everyone is clear both from the direction the Chancellor is giving and from the signals which we will set for the new management. They need to manage this risk of making sure that business as usual carries on in those specific mission critical projects like Tax Credit Renewal and they need that as their primary focus. It matters enormously to us that the revenue keeps coming in and Tax Credits keep being paid out.<sup>84</sup>

He went on to discuss the Government's general approach, citing the experience of merging the individual financial regulators into the Financial Services Agency:<sup>85</sup>

I had a personally very important and persuasive conversation with Howard Davies when I talked to him about setting up the FSA when he had the various different independent regulators and putting them into one. He said one of the things which was crucial in making a success of that is that people said to me, 'these are the strategic objectives go and do it.' They did not say how because I actually wanted the freedom to ensure that regulation could work through that period and do it in a way which minimised the risk of a transformation when you are trying to carry on doing business as usual. That is very important and we will need to learn from successful integrations that have taken place in the public and private sector to make sure we do not let that happen. I agree that it is really important we focus on that.<sup>86</sup>

On this question the Committee concluded, "we consider that tax collection and customer service must remain the departments' first priority during the merger process. We

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<sup>82</sup> *Ninth report: the merger of Customs & Excise and the Inland Revenue*, 3 November 2004 HC 556 2003-04

<sup>83</sup> HC 556 2003-04 Ev Qs 27-28

<sup>84</sup> HC 556 2003-04 Ev 4-5

<sup>85</sup> General background on the FSA is given in, "Financial Services and Markets Act 2000", Library standard note SN/BT/538, 27 September 2000. Howard Davies was Chairman and Chief Executive of the FSA from its creation in 1997 to September 2003.

<sup>86</sup> HC 556 2003-04 Ev Q 28

recommend that this be clearly articulated by Ministers and senior management to ensure that in the event of conflicting priorities it is clear which takes precedence.”<sup>87</sup> Overall the Committee stated that the merger was “desirable in principle” although it noted that some witnesses “expressed doubts that existing levels of service could be maintained, particularly in view of the significant staff reductions that are planned.”<sup>88</sup>

### C. Staffing implications

In 2003-04 there were some 77,300 staff in the Revenue and some 22,400 in Customs.<sup>89</sup> When he announced the merger the Chancellor also announced that the budget of the new department would be cut “in excess of 5 per cent in real terms” by 2008. Staff numbers would be cut by a gross figure of 14,000 with 3,500 redeployments – a net reduction of 10,500 by 2008.<sup>90</sup> On 1 April the Chancellor gave more details explaining, “of the 14,000 job reductions by 2007–08, 8,000 will be made by the Inland Revenue, 3,000 by HM Customs and Excise and 3,000 will result directly from the merger.”<sup>91</sup>

The wider reductions in staff numbers for HMRC are associated with reforms which will affect the entire civil service, following the Gershon review of public sector efficiency.<sup>92</sup> The review was published alongside the 2004 Spending Review on 12 July 2004;<sup>93</sup> in his statement to the House the Chancellor noted that, “following further detailed work, the merged Inland Revenue and Customs and Excise are announcing today that the gross reduction in their posts, which was provisionally set at 14,000, is now set at 16,000.”<sup>94</sup> In October the departments published a note to set out “how HMRC proposes to measure and monitor progress against the efficiency target set out in the Spending Review 2004.”<sup>95</sup>

In evidence to the Treasury Select Committee in October, David Varney – chairman of the two departments – said the projected net figure for job reductions was now 12,500 – the merger accounting for 3,500 of this figure.<sup>96</sup> James Plaskitt asked Mr Varney about this revised estimate, and whether he anticipated any compulsory redundancies:

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<sup>87</sup> HC 556 2003-04 para 31

<sup>88</sup> HC 556 2003-04 para 30

<sup>89</sup> HC 556 2003-04 para 16

<sup>90</sup> HC Deb 17 March 2004 c 331

<sup>91</sup> HC Deb 1 April 2004 c 733

<sup>92</sup> For details of this see, “The Lyons and Gershon reviews and variations in civil service conditions”, Library standard note SN/PC/2588, 21 July 2004.

<sup>93</sup> Details for the Chancellor’s departments are given in chapter 21 of HM Treasury, *Spending review 2004: public service agreements 2005-2008*, Cm 6238 July 2004 (pp 165-8).

<sup>94</sup> HC Deb 12 July 2004 c 1130

<sup>95</sup> *HM Revenue & Customs Efficiency Technical Note*, 29 October 2004. This is available at:

[http://www.inlandrevenue.gov.uk/psa/hmrc\\_etn.pdf](http://www.inlandrevenue.gov.uk/psa/hmrc_etn.pdf)

<sup>96</sup> HC 556 2003-04 Ev Qs 242, 244

**Q245 Mr Plaskitt:** So that has gone up by 500 from what Mr O'Donnell told us in April because he then said it was 3,000; you have increased that, have you?

**Mr Varney:** Yes, I have a number which is running, 3,200; these numbers move around. The point I think I made to the Committee is that we do not have today a plan which I am prepared to die for, which I have worked all the way through, otherwise I would have talked to the employers who would be affected. We have been going through a process of getting an allocation of money and numbers; it is not unusual in a plc—and in my experience I have done it frequently—of the business saying what it can do and the finance department saying, "We need more than that and here is the spec." That is in the nature of the debate.

**Q246 Mr Plaskitt:** Are you going to be able to achieve the 12,500 net losses and avoid compulsory redundancies?

**Mr Varney:** I hope so, but let us be clear that they are job reductions and we have a buoyant economy at the moment—I think we reported today the greatest number of people in work—so we are going to have labour turnover. Nobody wants to go for compulsory redundancies unless it is absolutely avoidable. I am not ruling it out, but I am not seeking it.<sup>97</sup>

In this context the Committee were critical that the Treasury had not published "a detailed analysis quantifying the expected costs and benefits" of the merger.<sup>98</sup> In his evidence Mr Varney explained that the "sheer size and complexity" of the Revenue and Customs meant that quantifying actual costs and savings would take some time:

If it had been a six-week job I think O'Donnell would have probably got to the bottom of it. I think one of the issues is the sheer size and complexity of the two organisations. If you have 98,000 full-time employees, equivalent, which is actually 106,000 people on 1 April, spread over 300 locations, of which 93 are in common; 24 locations have more than 1000 staff, that is 65% of the staff; you get to 40 locations you get to 75% of the staff; 170 locations have less than 100 staff and they are 8% of our staff in total; and 24% of our staff is in London and the south-east.<sup>99</sup>

Indeed one practitioner writing on *O'Donnell* argued that it would be some time before the benefits of a merger could be properly assessed: "Many improvements could arise from a merger. Simplifications can be introduced. Duplications removed. Better results will arise from superior use of data. Will these benefits arise? This will not be known for many years."<sup>100</sup>

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<sup>97</sup> HC 556 2003-04 Ev 35

<sup>98</sup> HC 556 2003-04 para 20

<sup>99</sup> HC 556 2003-04 Ev Q 206

<sup>100</sup> "The future of tax", *Tax Journal*, 19 April 2004 p 9

## D. Formulating tax policy

In February 2001 the Treasury Committee published a report on the Treasury in which it questioned the Treasury's "capacity to analyse detailed tax issues and to take a more strategic view of the tax system and of the impact of taxes on the economy than hitherto."<sup>101</sup> Several witnesses had argued that there was a "lack of knowledge of tax" within the department:

The Treasury has an objective to promote a "fair and efficient tax and benefit system", which Mr Edward Troup, of Simmons & Simmons,<sup>102</sup> argued it was largely failing to achieve. He called for a more coherent framework for the tax system, a more analytic background to policy decisions, and more technical expertise in the Treasury so that debate with the revenue departments on complex tax issues could be engaged in more equally.

Mr Troup argued that the "principal failing ... is the lack of a coherent centre within which all the competing interests in making a good tax policy can be brought together" principally because there "was the lack of knowledge of tax within the Treasury itself". Some of Mr Troup's comments were echoed by the Chartered Institute of Taxation and the Institute and Faculty of Actuaries in their memoranda.<sup>103</sup>

In late 2000 the Inland Revenue's policy-making function had been the subject of a review, led by the permanent secretary of the Department of Health. Although the report stated that "at its best, the policy-making function in the Inland Revenue works very well", it suggested there were a number of areas that needed attention, including, "the ways in which links are made between different parts of the tax system and in which cross-cutting issues are approached" and, "the relationship with the Treasury."<sup>104</sup> One particular criticism was that "it remains difficult to identify anyone in the structure who has the background and the capacity to think about the tax system as a whole."<sup>105</sup>

In its response to the Committee's report the Government stated, "[the Treasury's] role is to co-ordinate, to take an overview of tax policy, and to ensure consistency with other areas of Government policy. Greater intervention by the Treasury in the details of the Revenue Departments' policies would be inconsistent with the more strategic role for the Treasury which both the Government and the Committee support."<sup>106</sup> However the

<sup>101</sup> *Third report: HM Treasury*, 1 February 2001 HC 73 2000-01 para 45

<sup>102</sup> As noted above, Mr Troup is now at the Treasury, and has argued in favour of a merger of the revenue departments for some time.

<sup>103</sup> HC 73 2000-01 para 43

<sup>104</sup> Inland Revenue, *Architectural Engineers: a Peer Review of the Inland Revenue's Policy Making Function*, October 2000 paras 7-8. Available at: <http://www.inlandrevenue.gov.uk/about/peer.pdf>. The report was discussed in, "Revenue criticised over tax policy-making", *Financial Times*, 3 January 2001 & "Tax with no return", *Guardian*, 9 January 2001.

<sup>105</sup> *Architectural Engineers*, October 2000 para 24

<sup>106</sup> Treasury Committee, *Eighth special report*, 10 December 2001 HC 429 2-001-02 para (t)

O'Donnell review highlighted several areas in the current arrangements "where improvements could be made":

- increased capacity for high level economic analysis of tax issues and for taking a strategic overview of the tax system. Since 1997 numbers in the Treasury working on tax have increased, but capacity in this area has not changed adequately to meet the long-standing policy challenges. Strategic overview must be informed by understanding of the detailed working of the tax system. While staff in the revenue departments are well placed to consider parts of the tax system, they are not well placed to take a holistic view;
- increased focus on cross-cutting issues and coherence. Many of those working on tax in the revenue departments cover single taxes and are often experts in that tax. This structure means that while there is a good capability to make adjustments on a tax-by-tax basis, it is much harder to make policy on issues that touch on a large number of taxes or assess likely effects of specific changes that have consequences in other areas; and
- greater clarity of roles on policy both as a desirable outcome in its own right, and because it became apparent in informal discussions with external stakeholders that the respective policy roles of the Treasury and the revenue departments were not well understood.<sup>107</sup>

*O'Donnell* recommended "a new division of work between the Treasury and the new department, designed to build upon their comparative advantages":

The Treasury would lead on strategic work and policy development, and the new department would lead on policy maintenance and delivery. To ensure continued joining up and partnership working, both departments would assist the other in the discharge of its duties. As part of this, the Treasury's capacity to advise on tax policy should be enhanced. For the operational policy that remains in the revenue department, the creation of the new department will help to ensure coherence across the tax system.<sup>108</sup>

Further to this, "the new and clarified roles and responsibilities should be set out in a new Framework Document" and, "the Chancellor should also issue an annual Remit to the revenue department as part of the budget process ... [to] describe in outline any changes in the main tasks of the new department for the year, and set out any new approach to policy maintenance."<sup>109</sup>

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<sup>107</sup> *O'Donnell* para 5.28

<sup>108</sup> *O'Donnell* para 1.28

<sup>109</sup> *O'Donnell* para 1.31



In a written statement in October 2004 the Paymaster General announced that these new arrangements were in place:

#### **Responsibility for Tax Policy**

**The Paymaster General (Dawn Primarolo):** In line with the recommendations of the O'Donnell review and the Chancellor's Budget statement in March, the new arrangements for the development and maintenance of tax policy are now in operation. HM Treasury has assumed responsibility for policy development, working very closely with Inland Revenue and Customs and Excise. Copies of the O'Donnell report are available in the House Libraries.<sup>110</sup>

In their report on *O'Donnell* the Treasury Committee endorsed these “steps to strengthen the Treasury’s capacity in this area” but noted the concerns expressed by several witnesses that “the arrangements adopted may detach policy-making from implementation and operations.”<sup>111</sup> As a first step, Nick Macpherson, the managing director of the new office – HM Treasury’s Budget and Public Finance Directorate – gave more details of its work in a recent article for the *Tax Journal*,<sup>112</sup> which in turn elicited a couple of responses from the profession.<sup>113</sup>

The responsibilities of the Treasury and HMRC have been set out by Gus O’Donnell:

As a result, the Treasury is now responsible for strategy and tax policy development and HM Revenue and Customs will be responsible for policy maintenance. Of course, this begs the question about the difference between strategic policy and policy maintenance. In my view, it will be clear cut in the very great majority of cases. However, when it is less clear it is important to remember that HM Treasury and HM Revenue and Customs have joint responsibility for the tax system as a whole, and as the policy partnership develops the departments will work closely together to find practical ways to solve any emerging problems.<sup>114</sup>

In his ICAEW lecture Mr O’Donnell discussed the Treasury’s “new, enhanced tax capacity”, explaining that when formulating advice on tax policy questions “the Treasury now concentrates on key themes, some of which I will now list”:

1. What is the impact on potential growth in the economy?
2. Horizontal Equity: are individuals with similar circumstances treated the same?
3. Vertical Equity: Is the amount paid greater for those with greater ability to pay?
4. Incidence: who really bears the burden of paying a tax?

<sup>110</sup> HC Deb 11 October 2004 c 1WS

<sup>111</sup> HC 556 2003-04 para 52

<sup>112</sup> “Tax policy-making under O’Donnell”, *Tax Journal*, 11 October 2004

<sup>113</sup> “The tax policy tango” & “A smarter tax process”, *Tax Journal*, 25 October & 1 November 2004

<sup>114</sup> 12<sup>th</sup> ICAEW Tax Faculty Hardman Memorial Lecture, 18 November 2004 p 8

5. Intergenerational Fairness: are present and future generations affected in similar ways?
6. Business Impact: Are SMEs or large businesses affected most by proposed changes?
7. Sectoral impact: are particular sectors of the economy likely to be affected inappropriately by specific policies or sets of policies?
8. Environmental Impact: what role can and should fiscal policy have in supporting environmental goals, through encouraging behavioural changes in consumption for example?
9. Regional Impact: are particular regions or nations likely to be disproportionately affected by proposed policies?
10. Market Failures: Does the proposal reduce the wedge between marginal private costs and social costs?<sup>115</sup>

## **E. Ministerial responsibilities**

On 4 October 2004 the Government announced that the Paymaster General would be departmental Minister for HM Revenue and Customs.<sup>116</sup> In his ICAEW lecture Mr O'Donnell said, "the role of Ministers here is crucial ... I think therefore it was both inevitable and correct that under the new administrative structures we would move to having a single Minister responsible within the Treasury for the new department and strategic oversight of the tax system. Dawn Primarolo, the Paymaster General, is now that Minister."<sup>117</sup> David Varney gave evidence to the Treasury Committee following this statement, on 13 October 2004, pointing out that he would be reporting to three Treasury Ministers on various aspects of the new department's work:

**Q273 Chairman:** Can you clarify for us the position so far as accountability to ministers is concerned. According to the announcement on Monday, the Paymaster General will be the Departmental Minister responsible for Revenue and Customs, however the website still lists the Economic Secretary as retaining responsibility for excise duties. Can you help us with that?

**Mr Varney:** That was in the announcement, that he has still got that responsibility.

**Q274 Chairman:** So you will still be accountable to two ministers?

**Mr Varney:** For various aspects and, in fact, three because there are some things that I report to the Financial Secretary on. There are issues to do with the City, various things that come across my desk, that will go to the Financial Secretary.

**Q275 Norman Lamb:** Why the divide? Why have one minister responsible for excise duty and gambling? If you are merging the two departments, surely it would make sense to have one minister responsible?

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<sup>115</sup> 12<sup>th</sup> ICAEW Tax Faculty Hardman Memorial Lecture, 18 November 2004 p 12

<sup>116</sup> HC Deb 4 October 2004 c 1791W

<sup>117</sup> 12<sup>th</sup> ICAEW Tax Faculty Hardman Memorial Lecture, 18 November 2004 p 8

**Mr Varney:** With great respect, I think I am probably not able to give you the sort of quality answer you could get from some other people in the Department.

**Q276 Chairman:** You mean you are as mystified as we are?

**Mr Varney:** You might say that, I could not possibly comment.<sup>118</sup>

Subsequently Mr Varney wrote to the Committee to clarify the issue; an extract is given below:

The formation of HMRC ensures that a single Treasury Minister is the departmental lead for both revenue and customs functions. The Paymaster General is the departmental Minister for HM Revenue and Customs. I am the accounting officer who reports to the PMG on departmental issues and running the department.

The tax system impacts on a wide range of Treasury policies. As with previous governments different Ministers lead on policies that also cover taxation. The Economic Secretary's areas of policy responsibility that also cover taxation include small business taxation, transport taxation and excise duties (including the excise fraud strategies). The Financial Secretary, as the lead Minister on Financial Services, also has responsibility for some areas of policy that include taxation including issues such as ISAs, the taxation of savings, stamp duty and pensions.

The PMG has strategic oversight for the tax system as a whole. Both the Economic Secretary and Financial Secretary update and consult with the Paymaster General as a matter of routine to keep her fully informed of policy developments which impact on her wider areas of responsibility. The Chancellor has overall responsibility for the Chancellor's departments.<sup>119</sup>

Nevertheless the Committee were of the opinion that the arrangement “appears cumbersome” and should “be reviewed in the light of practice after the new department has been created.”<sup>120</sup>

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<sup>118</sup> HC 556 2003-04 Ev 38

<sup>119</sup> Letter from David Varney, Chairman, Inland Revenue and HM Customs and Excise, 15 October 2004 (HC 556 2003-04 Ev 68).

<sup>120</sup> HC 556 2003-04 para 57

## IV The Bill

### A. Introduction

When the O'Donnell review was published in March 2004 the Government stated that it would "legislate to establish the new department as soon as Parliamentary time allows."<sup>121</sup> *O'Donnell* noted that legislation would be needed to implement part of the package of its recommendations:

#### Legislation

6.55 The review's recommendations on policy and accountability do not require legislation, and can be implemented through administrative changes. However, the integration of the revenue departments into a single department, and the changes on information will require legislation. This should address the following issues:

- organisation and structure of the new department, to provide for its financing, and to define the relationship between the Treasury and the new department;
- information sharing within the revenue department, and between the new department and other bodies, subject to the need to preserve taxpayer confidentiality;
- powers of the new department to audit and investigate and to deal with non-compliance;
- other synergies, such as an integrated debt collection facility.

6.56 Legislation should be brought forward when parliamentary time allows.<sup>122</sup>

The Queen's Speech on 23 November 2004 included, "my Government is committed to reducing bureaucracy and the costs of Government, and to promoting efficiency. A Bill will be introduced to integrate the Inland Revenue and Her Majesty's Customs and Excise."<sup>123</sup> The *Commissioners for Revenue and Customs Bill* was introduced in the Commons on 24 November 2004. The purpose of the Bill was set out in a press notice issued the following day; an extract from this is given below:

Improved customer service for businesses and individual tax payers will be delivered through the new HM Revenue and Customs government department (HMRC), introduced in a Bill published by Paymaster General Dawn Primarolo today. The Commissioners for Revenue and Customs Bill will integrate Inland Revenue and HM Customs & Excise into the new single department, created as a result of the O'Donnell review of revenue administration, published alongside Budget 2004. The new department will bring significant benefits including:

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<sup>121</sup> HM Treasury press notice 27/04, 17 March 2004

<sup>122</sup> *O'Donnell* p 126

<sup>123</sup> HL Deb 23 November 2004 c 3

- delivering improvements for customers, through more effective, joined-up services;
- improving fairness by making better use of information across HMRC which will help target compliance activities, thereby reducing the burden on honest taxpayers; and cracking down on those trying to abuse the system; and
- delivering efficiency improvements, with integration contributing 3,000 posts towards total savings in HMRC of 16,000 posts by the end of 2007/08, as set out in the Spending Review earlier this year.

The Bill also creates a new independent prosecutions office - the Revenue and Customs Prosecutions Office (RCPO) - to prosecute HMRC cases in England and Wales, implementing a key recommendation of the Butterfield Review. The creation of RCPO will:

- demonstrate the full independence of the prosecutors and ensure that the public can have confidence in their credibility and integrity.
- introduce external scrutiny of criminal investigation work,
- improve standards and effectiveness; and
- make the staff of the office, through the Director, accountable to the Attorney General.

Introducing the Bill, the Paymaster General Dawn Primarolo said: “We are committed to ensuring that our tax administration is best placed to deliver the best possible service to taxpayers. The establishment of HMRC, integrating the work of Customs and the Revenue, represents a major contribution to the Government’s public service reform agenda, aimed at delivering real service improvements for people and businesses throughout Britain.”

The Attorney General Lord Goldsmith said: “Public confidence in the criminal justice system is crucial. The establishment of RCPO, responsible for the prosecution of all Revenue and Customs cases in England and Wales and accountable to me, is an important step to ensure there is an effective and fully independent prosecuting authority dealing with many of the most difficult and complex cases in the criminal justice system.”<sup>124</sup>

It is expected that the Bill will have its second reading on 8 December 2004.<sup>125</sup>

It is estimated that the merger “will lead to initial costs of around £75 million over the two financial years 2004/2005 and 2005/2006.” The cost of transferring the Revenue’s prosecution function to the new Revenue and Customs Prosecutions Office (RCPO) is estimated “to be around £240,000.”<sup>126</sup>

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<sup>124</sup> HM Treasury press notice 96/04, *Publication of the Commissioners for Revenue and Customs Bill*, 25 November 2004

<sup>125</sup> HC Deb 25 November 2004 c 231

<sup>126</sup> Bill 3-EN para 284

## **B. The choice of a ‘short early Bill’**

Alongside the Bill the Treasury published a regulatory impact assessment (RIA) which examined three options to the legislative approach to implementing the merger:

- i. a short early Bill, which contains those provisions that are essential to create HMRC and permit it to function effectively. This could mean that further legislation might be required at a later date to make any more substantive changes that might be needed to reap the full benefits;
- ii. a more comprehensive early Bill, which contains all the essential content of option (i) above, but also makes more substantive changes in areas such as the powers vested in officers to carry out their functions, or to the mechanics of some business processes (where underpinned by legislation) to facilitate more areas of joint working across indirect and direct taxation; or
- iii. a fully comprehensive Bill in a later legislative session following detailed analysis of the most appropriate strategy for the new department and assessment of the legislative changes needed to underpin that strategy.<sup>127</sup>

The Bill represents the first of these options. As a consequence some issues remain unresolved: for example, information. One of the main benefits to a merger recognised by *O’Donnell* was a “more coherent use of information”. Merging the two departments requires the legal framework underpinning these activities – ensuring the confidentiality of taxpayer information – to be reformed. The review saw this as an opportunity to “consider how data can best be used to improve risk assessment, customer service, and policymaking”:

Confidentiality requirements mean that disclosure of taxpayer or claimant data to other bodies, including between the revenue departments, must be legally justified – usually by a statutory gateway. The principal gateway between the revenue departments, Section 127 of the Finance Act 1972, is extensive, providing that Commissioners or authorised officers of the Revenue and Customs may disclose information to one another and use information received from the other “for the purpose of assisting them in the performance of their duties.” This gateway allows officers of the revenue departments to share, for example, information relating to an individual case of fraud, or information to improve risk assessment on a specific business sector. Care is taken to ensure only relevant information passes ... The Treasury, in partnership with the new revenue department, should bring forward legislation to allow the best use of information in the new department, to improve customer service, effectiveness, and support

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<sup>127</sup> HM Treasury, *Regulatory Impact Assessment: the Commissioners for Revenue and Customs Bill*, November 2004 para 15

for policy, taking account of the need to preserve confidentiality and proportionality.<sup>128</sup>

Intertwined with these requirements are the statutory rules establishing each department's enforcement powers. *O'Donnell* recognised that there are important differences between the Revenue and Customs in this respect – for example, in powers to gain entry to premises. Merging the two departments would require an alignment of these powers, and again, offered an opportunity to review these rules as a whole:

There are good reasons for different powers in some circumstances. However, the creation of an integrated department will allow an overview to be taken of powers, and their impact on information use. There is a balance to be struck between lowering compliance costs for customers, and ensuring that the right information is collected to inform future development and analysis. The right technical solutions and use of information, for example collecting basic data on a once-only basis and/or through electronic channels, can ensure that costs are lowered without leaving out data that may be important. There is therefore an important link between powers and information strategy, and the powers of the revenue department will need to be considered as part of the legislation to establish the new department.<sup>129</sup>

In evidence to the Treasury Committee the Law Society stated that the merger was “long overdue”, but it had particular concerns about how each department's powers would be aligned:

Any legislation necessary to harmonise information and enforcement powers will need to take account of the significant differences in the definitions used within the tax system. This is a major opportunity to produce a coherent and sensible set of enforcement rules which should not be rushed into by simply bolting legislation (principally the Taxes Management and the Customs & Excise Management Acts) together. There should be full consultation on making the powers consistent and appropriate for the new Revenue authority.<sup>130</sup>

Prior to the introduction of the Bill, David Varney, chairman of the two departments, gave evidence to the Treasury Committee on 13 October 2004; Norman Lamb asked about the difference in powers each department had at its disposal:

**Q265 Norman Lamb:** ... The powers on the Customs' side are in some cases very draconian ... Are you comfortable with the extent of the draconian nature of those powers?

**Mr Varney:** Let me give a general answer. Customs and Excise have come out of an environment and are part of a tax system where an entity is taxed in real

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<sup>128</sup> *O'Donnell* paras 1.5, 4.20-1

<sup>129</sup> *O'Donnell* para 4.22

<sup>130</sup> HC 556 2003-04 Ev 60

time and if you do not stop it, it disappears. The Revenue has more time because they can do investigations and they can always reopen cases within a certain period of time. I think the proposition we will be putting, if the Bill is introduced, will be to keep the powers that each individual tax activity has in place and to accept that when HMRC is up and running we will look again at the question of proportionality of powers in the context of broader institutions that exercise powers of enforcement.<sup>131</sup>

The RIA on the Bill summarised the case for a “short, early Bill”:

The key benefit of this option is that it enables the new department to be established quickly, allowing work to begin early on what are likely to be major organisational and administrative changes, in order to deliver the benefits of integration. It would allow the new department to come into existence around a year or so after the announcement of the intention to integrate. In addition, by focussing the legislative changes on those essential for the new departments effectiveness, it reduces the risk to business as usual which could arise under option (ii).<sup>132</sup>

While the Bill transfers the information and enforcement powers of the two departments to HMRC, it ‘ring fences’ them “so that they may only be used in respect of the functions of the specific predecessor department.”<sup>133</sup> The explanatory notes to the Bill summarise the provisions relating to the new department’s functions and powers:

**Functions and powers (clauses 4 to 6 and 15 and Schedules 1 and 2, Part 1)**

The Commissioners will be responsible for all the functions (bar prosecutions as a result of clause 31), which were previously the responsibility of the Commissioners of Inland Revenue and the Commissioners of Customs and Excise. Officers will be able to exercise all of the functions of Inland Revenue and Customs and Excise officers, unless stated otherwise.

The Bill identifies all of the functions previously carried out by the Inland Revenue (see Schedule 1). It provides that powers previously available to the Commissioners of Customs and Excise and their officers may not be used for these former Inland Revenue functions, while powers previously available to the Commissioners of Inland Revenue and their officers may only be used for these functions. This is to prevent any inadvertent widening of powers in the new department.<sup>134</sup>

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<sup>131</sup> HC 556 2003-04 Ev 37

<sup>132</sup> *Regulatory Impact Assessment*, November 2004 para 16. As noted above, ‘option (ii)’ was for a “more comprehensive early Bill” to include “more substantive changes in areas such as the powers vested in officers to carry out their functions” (*op.cit.* para 15).

<sup>133</sup> *Regulatory Impact Assessment*, November 2004 para 10

<sup>134</sup> Bill 3-EN para 8-9



In its conclusions on *O'Donnell*, the Treasury Committee recognised “the pragmatic nature” of such an approach:

However, we are concerned that the powers the new department needs to discharge its functions should be subject to proper parliamentary scrutiny. We would therefore welcome a firm commitment from the Government to introducing ‘second stage’ legislation as soon as possible and recommend that this be in the form of a draft bill.<sup>135</sup>

The Government has not given its response to the Committee’s report to date, and it does not appear to have made a statement about ‘second stage’ legislation as yet.

### C. Customs prosecutions and the Serious & Organised Crime Agency

In recent years a number of high profile criminal prosecutions by HM Customs & Excise have collapsed, leading to a series of official enquiries.<sup>136</sup> In December 2000 the ‘Gower & Hammond’ review was published,<sup>137</sup> which led – in April 2002 – to the Solicitor’s Office of HM Customs & Excise being split in two: a departmental Solicitor’s Office and a Prosecutions Group. Accountability for the care and management of prosecutions was passed to the Attorney General. Further changes were introduced in April 2003: the Prosecutions Group adopted the name “HM Customs & Excise Prosecutions Office” and the reporting line of that Office was moved to the Attorney General. A Memorandum of Understanding (MOU) was signed by the Attorney General, the Economic Secretary to the Treasury, and the Chairman of Customs to set out how the future arrangements within which the Office would operate.<sup>138</sup>

In July 2003 a further official enquiry – the ‘Butterfield review’ – argued that the Solicitor’s Office “should no longer retain any responsibility for prosecutions brought by Customs & Excise. All prosecuting functions should be removed from the Customs & Excise Solicitor’s Office and prosecutions conducted by a separate prosecuting authority.”<sup>139</sup> The Government accepted this recommendation in December that year, and that the new authority would be established “during the course of 2004.”<sup>140</sup> Following the

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<sup>135</sup> HC 556 2003-04 par 45-46

<sup>136</sup> As noted above, further background on this issue is given in Library standard note SN/BT/2944, 26 November 2004.

<sup>137</sup> *Report of the review of prosecutions conducted by the Solicitors Office of HM Customs and Excise by His Honour John Gower, QC and Sir Anthony Hammond, KCB, QC*, 5 December 2000 [Deposited paper 01/370]

<sup>138</sup> The MOU is reproduced in Appendix Nine (pp 343-360) to the ‘Butterfield review’, cited below.

<sup>139</sup> HM Treasury, *Review of criminal investigations and prosecutions conducted by HM Customs and Excise: report by the Honourable Mr Justice Butterfield*, 15 July 2003 [Deposited paper 03/2000] p 10

<sup>140</sup> HC Deb 8 December 2003 cc 72-3WS

announcement of the merger, the Attorney-General (Lord Goldsmith) announced on 12 October 2004 that a single prosecuting authority would be established.<sup>141</sup>

The new Revenue and Customs Prosecutions Office (RCPO) is to be an entirely separate prosecuting authority, accountable to the Attorney-General, responsible for the prosecution of all HM Revenue and Customs cases in England and Wales. Legislation to this effect is included in the Bill.<sup>142</sup> The RIA judges that the inclusion of the Revenue's prosecution work in the new statutory body will have a "neutral" impact:

Our reasons for considering the impact to be neutral (or a modest improvement for stakeholders in the prosecution process) are:

- the transfer of responsibility from the Board of Inland Revenue to the successor to the Customs and Excise Prosecution Office for the prosecution of offences previously under the care and management of the Board is essentially a machinery of government issue, resulting from the integration of the Revenue Departments;
- the Customs and Excise Prosecution Office was created to prosecute offences against Customs and Excise in order to demonstrate the clear independence of the prosecutors from the investigators in those cases, so this is about raising standards;
- to the extent that the Customs and Excise Prosecution Office is taking on Customs cases, this is to deliver the benefits identified in the Butterfield Report. To the extent that it is to deliver Inland Revenue cases, this is a process change caused as a result of the integration of the Revenue Departments. The Butterfield recommendations did not apply to Inland Revenue cases, but if there is any impact on the stakeholders in these prosecution cases caused by these changes, then it is even greater clarity that the prosecuting process is indeed independent and objective. This is considered desirable by all parties who have expressed a view.<sup>143</sup>

In February 2004 the Home Office announced the creation of a new agency – the Serious and Organised Crime Agency (SOCA) – to bring together the responsibilities which currently fall to the National Criminal Intelligence Service, the National Crime Squad and Home Office responsibilities for organised immigration crime, as well as the investigation and intelligence responsibilities of Customs and Excise in tackling serious drug trafficking and recovering related criminal assets.<sup>144</sup> Full details were given in a white paper published in March.<sup>145</sup> In July 2004 Mike Eland, acting chairman of Customs, gave evidence to the Treasury Committee; Robert Walter asked about the future division of responsibilities between SOCA and Customs:

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<sup>141</sup> HL Deb 12 October 2004 c 9WS

<sup>142</sup> specifically clauses 30-37, 44 and schedule 3 (Bill 3-EN para 23-25)

<sup>143</sup> *Regulatory Impact Assessment*, November 2004 para 68

<sup>144</sup> Home Office press notice, *New UK-wide organised crime agency pooling expertise to track down the crime bosses*, 9 February 2004

<sup>145</sup> Home Office, *One step ahead: a 21st century strategy to defeat organised crime*, Cm 6167 March 2004

**Q9 Mr Walter:** The other principal structural initiative [to the Revenue/Customs merger] is the announcement which the Government made in February of the creation of a Serious Organised Crime Agency. How will responsibility for tackling drug-smuggling be divided between Customs and this Serious Organised Crime Agency, SOCA, is that what we are supposed to call it?

**Mr Eland:** Yes. SOCA is the name which tends to be used. The work into serious drug-smuggling, the large-scale investigations that we do, will transfer into the new Agency along with many of the investigators who are working on it currently in the department. The activity at the frontier in relation to drugs will remain with Customs, so Customs will continue to play a role at airports and ports in looking for drugs interdiction. They will carry forward any subsequent investigations or court action in relation to that, unless it is part of a wider picture, in which case it will be transferred to SOCA. It is a question of scale really.<sup>146</sup>

The new agency is to be established by the *Serious Organised Crime and Police Bill* (Bill 5 of 2004/05), which was introduced on 24 November 2004.<sup>147</sup>

## D. Initial reactions to the Bill

The Bill appears to be relatively uncontroversial. A number of Members referred to its inclusion in the Queen's speech on the first day of the Debate on the Address on 23 November. Charles Kennedy, leader of the Liberal Democrats, expressed the hope that computer systems failures – as seen recently with the Child Support Agency – “[would] not arise with the integration of the Inland Revenue with Customs & Excise.”<sup>148</sup> Concerns about IT systems were also expressed by Brian White who, while welcoming the Bill, noted, “there are important issues of culture in the different organisations and we need to get them right”:

As a former Customs officer, I have an interest in the Bill on merging Customs and the Inland Revenue. I was around in Customs at the time when they had just brought in other Government Departments or OGDs, as they are called, and were allowing members of the civil service to work in Customs. I remember the resistance to such an approach at that time, and I urge Front-Bench colleagues not to underestimate the complexity of merging Customs and the Inland Revenue. When mergers happen, it is important that we get the culture of the new organisation right at the beginning. If we do not do so, there will be problems. It is important that we set out what it is essential to get right straight away and what

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<sup>146</sup> *Minutes of evidence: HM Customs & Excise Spring Departmental Report 2004*, 21 July 2004 HC 908-i 2003-04 Ev 2. Customs' future role at airports and ports was also set out in answer to a PQ at this time: HC Deb 10 June 2004 cc 486-7W.

<sup>147</sup> Details are given in two Library Research papers: *The Serious Organised Crime and Police Bill: the New Agency; and new powers in criminal proceedings* 04/88, & *The Serious Organised Crime and Police Bill: Police Powers, Public Order and Miscellaneous Provisions* 04/89, 2 December 2004.

<sup>148</sup> HC Deb 23 November 2004 c 35

can wait for the long term. We must give people the skills to deal with constant change and recognise the dangers that are involved in the merger. We should get the computer systems right and recognise that there are things that the Revenue does differently from Customs and from the Treasury. We must also recognise that there are important issues of culture in the different organisations and that we need to get them right if there is to be a successful merger. I welcome the Bill and the work that the Select Committee on the Treasury has done on this matter, which I think will benefit us in the long run. It is not a simple process, however, and we should not underestimate it.<sup>149</sup>

Michael Fallon referred to the work of the Treasury Select Committee on *O'Donnell*, and their concerns about culture and confidentiality:

The Treasury Committee reported on the O'Donnell review ... and I hope that the Bill that is introduced to complete the merger takes account of our two major concerns. First, we were concerned that merging two very large organisations with very different cultures should not put at risk the collection of the revenue and the service that individual and business taxpayers deserve to receive. Secondly, confidentiality should be protected and indeed enhanced in statute. That is all the more important because the two departments and their policy-making arms are now being moved into the Treasury building itself, and the arm's length relationship that should exist between Treasury Ministers and Revenue officials may become all the more suspect when they are sharing the same corridor, building or cafeteria.<sup>150</sup>

Oliver Letwin, shadow Chancellor, mentioned the Bill at the opening of his speech on the sixth day of the Debate on the Address, when he said:

Before I begin discussing the main substance of today's debate, I want to make a few remarks about the Bills in the Queen's Speech relating to the economy. The Treasury's Bill on the merger of the Inland Revenue and Customs and Excise carries our general support, as the Chancellor is aware, although we remain concerned about its practical implementation. We are dealing with two organisations that have between them 250 legacy computer systems and some 13 million customers. It is no mean feat to put them together, and we will want to look at the details extremely carefully.<sup>151</sup>

In the same debate Vincent Cable, Liberal Democrats spokesman, simply said, "we support the practical measures on the Inland Revenue and Customs and Excise in the Queen's Speech."<sup>152</sup>

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<sup>149</sup> HC Deb 23 November 2004 c 48

<sup>150</sup> HC Deb 23 November 2004 c 76

<sup>151</sup> HC Deb 1 December 2004 c 636

<sup>152</sup> HC Deb 1 December 2004 c 656