

## **COMPLIANCE COST REVIEW**

### **CONSTRUCTION INDUSTRY SCHEME (CIS) – DEDUCTION OFFSETTING**

#### **1. Introduction**

##### **1.1 Background**

In line with Government commitments to reduce the compliance burdens that are placed on businesses, HM Revenue & Customs (HMRC) assesses the likely change in compliance costs whenever a policy is introduced or changed. The results of that analysis are published in a final Regulatory Impact Assessment (RIA) when the associated legislation is laid before Parliament. Where a consultation document is published during the analysis period, it is accompanied by a partial RIA.

This document summarises the outcome of a post-implementation review of the final RIA that was published and implemented in April 2002 for the above-mentioned measure by the Inland Revenue (prior to creation of the new department, HMRC). A copy of the published final RIA is attached. Only the changes made in this particular RIA are considered here. Other changes, and the structure of CIS generally, are outside the scope of this particular review.

This review re-assesses the compliance cost analysis published in the original RIA and addresses two main questions:

- whether the estimates of compliance costs used in the RIA were correct, with hindsight; and
- whether the processes used to estimate compliance costs were appropriate and reasonable, given the circumstances at the time.

HMRC intend to use this review to improve the RIA process, and also to assist in future policy development and evaluation work in general. As such, the emphasis is on identifying learning points for future assessment of compliance costs. The review does not revisit the original policy decision.

#### **2. The published RIA**

##### **2.1 Description of the policy change**

The Construction Industry Scheme ensures that businesses in the construction industry comply with their tax and National Insurance contribution obligations. Briefly, companies, partnerships and self-employed individuals in the construction industry act as contractors, subcontractors or both. Subcontractors must register for the scheme

with HMRC before they can get paid by the contractor. If the subcontractor meets various qualifying criteria then they are issued with a Tax Certificate which allows them to be paid gross by their contractor. If the subcontractor doesn't meet the qualifying criteria then they are issued with a Registration Card. In that case, the contractor must make a deduction from payment of an amount on account of the subcontractor's tax and National Insurance contribution (NICs) liability.

At the time the RIA was written, the deduction rate from payments to Registration Card holders was 18%. This was fixed at a rate considered to be a reasonable estimate of the ultimate tax and NICs liability of individuals and partners on these payments. For companies, however, the deduction was found to be higher than the companies' final liability. Although any overpayments would be corrected at the end of the year, some companies may have incurred cashflow problems in the interim. The RIA addressed this by changing the rules so that the deduction could be offset against the company's other liabilities in respect of its obligations as an employer or contractor. The intended effect was to eliminate the cashflow impact, and so reduce the compliance burden.

The policy change was in fact suggested by business during consultation exercises in 2000. Accordingly, it was welcomed by them.

## **2.2 Anticipated compliance costs or savings**

The costs were assessed as being very low. They were:

- Short-term (one-off) costs associated with familiarisation with the new rules, IT and system changes, staff training. Not quantified separately.
- Long-term (recurring) costs associated with changes to forms (the change generated two extra boxes to complete on the P35 but removed one box from the Corporation Tax self-assessment return). Not quantified separately.
- Costs associated with accounting and recording data. Not quantified but were stated to be no more than the status quo.
- In summary, much of this activity was felt likely to be carried out by business anyway and therefore remain unaffected by the change. As such, the overall assessment of cost was very low and it was considered unnecessary to quantify the individual components.

The cashflow saving – which was the main benefit to businesses of the policy change – was not classed as a compliance cost saving in the RIA and hence technically is outside the scope of this review. It is clear from the way the change was supported by business that the cashflow benefits outweighed any increase in compliance costs.

## **3. Conduct of the review**

Each compliance cost review is conducted individually, and the review process is adapted to suit the particular circumstances applying in each case. The emphasis is on making sure that the review itself - and any burden of consultation - are sufficient to meet the objectives of the review, but proportionate to the likely benefits.

In this case, the review was led by an HMRC project team supported by consultants. The staff in the review team were completely independent of those involved with the original policy change.

An essential element of the review was consultation with those actually affected, and consultants were commissioned to carry out a small number of targeted in-depth interviews with some of those affected and their trade bodies. The research was not intended to deliver any degree of statistical robustness (to do so would have been costly and impractical) but instead to provide indicative findings. Coupled with the consultants' own knowledge and expertise, this has allowed the research to identify the major issues and any associated learning points.

The external research was complemented by an internal review of HMRC paperwork and electronic files.

#### 4. Were the original estimates of compliance costs accurate?

This section addresses two main aspects – the nature of the change in compliance costs (i.e. what did people have to do differently) and the monetary impact of that change (what did it cost or save them).

Question	Comments
Were the specific types of cost and benefit identified in the RIA incurred?	Yes. Respondents to the external research agreed with the types of cost and saving mentioned in the RIA. In some cases they disagreed about their magnitude: some agreed the costs were minimal, others felt that the RIA had underestimated them. All agreed that the cashflow benefits were being achieved where businesses were eligible. The RIA mentioned a number of consequential benefits (such as less debt or better compliance) and although there is no hard evidence available, it is reasonable to infer that the cashflow benefit will have helped some firms in these or other ways.
Were costs/savings incurred at the expected time?	In broad terms yes. However respondents noted that the timing of any cashflow benefits, and indeed the overall compliance cost, is very dependent on the “system” working efficiently. Sub-contractors need to obtain the necessary paperwork from contractors in order to operate the scheme, and any delays reduce the cashflow benefit and increase administrative costs. The RIA did not identify this risk.

<p>Were costs/savings incurred by the expected people?</p>	<p>Yes. The RIA quoted an estimate of 20,000 companies being affected. Respondents have confirmed that this was helpful but added that quoting the percentage of firms affected would have been useful too.</p>
<p>Were any other costs/savings, not identified in the RIA, incurred ?</p>	<p>The main concern was the timing issue mentioned above and the resulting administrative costs and delays (which could be significant).</p>
<p>If the type of costs/savings varied from the original estimates, why was that?</p>	<p>The original RIA did not provide a quantitative assessment of compliance costs: qualitative analysis was the best available at the time. Although in no way a statistically robust sample, half of those consulted believed that the RIA was about right or overestimated costs. The other half, including representatives from trade bodies, identified aspects of compliance costs that had exceeded the RIA assessment. However different people identified different costs: IT infrastructure costs, communication costs and training were mentioned by different people but not by everyone. In context, the particular change under review was minor and the costs low.</p>
<p>Could such variances have been foreseen at the time?</p>	<p>Respondents believe that the RIA should have identified the possible risk of delays obtaining paperwork, or at least explained that the RIA was assuming that that risk would be minimal. The other cost discrepancies tend to be case-specific. For example IT costs may be high for firms without existing infrastructure, or who incur annual charges from software providers. Training costs will vary according to staff turnover. Such discrepancies could not have been forecast accurately, but the fact that costs might vary could have been mentioned in the RIA to help those affected judge the likely impact on them.</p>
<p>What is the assessment now of the total value of costs and savings?</p>	<p>There are no quantitative estimates available, but the qualitative assessment remains that compliance costs were minimal (albeit slightly worse than predicted for some firms). The benefits outweighed the costs.</p>

If different from the original RIA, what has caused the discrepancies?	The most significant problem was the (with hindsight, unrealistic) assumption that sub-contractors would be able to obtain paperwork quickly enough to gain maximum benefit.
With hindsight, were the compliance cost estimates accurate?	No. However, the overall costs remain very low when compared with other policy changes. They are higher than predicted for some firms but the overall compliance cost assessment remains unchanged.

**5. Was the process used to estimate compliance costs reasonable?**

Irrespective of whether the analysis turned out to be correct, the review has considered whether the original analysis was completed in a reasonable way.

<b>Question</b>	<b>Comments</b>
Who worked on the original RIA?	All the appropriate people within the Inland Revenue were involved (policy owners, analysts, Better Regulation advisors etc.).
Was an adequate audit trail maintained?	Yes – although because the compliance costs were expected to be low, the focus tended to be on the benefits and other aspects of the change.
Was Cabinet Office and/or internal HMRC guidance on RIAs followed correctly?	Mostly. The RIA did not quantify compliance costs precisely (mainly because they were deemed to be low). The RIA did not mention any alternative options and could perhaps have done so.
How much effort was devoted to compliance cost estimation, and was that effort proportionate in the context of the policy measure?	The answer is minimal, but that this was indeed proportionate when compared with other policy changes at the time. The fact that business was pushing for the change implied that costs were not expected to be a problem. Having said that, the external research just completed has identified some concern that the RIA did not demonstrate a full appreciation of the internal systems used by business to process CIS and payroll data. The review team judges that this was a matter of the RIA not mentioning assumptions made, rather than a failure of understanding.

<p>Were the right people (both internal and external) consulted, and were their views reflected appropriately?</p>	<p>Yes. The compliance costs associated with making the change were not identified as a major issue at the time (either by government or by industry).</p>
<p>Did those who were consulted when the RIA was written express views on the reasonableness of the process?</p>	<p>There is no evidence of any particular problems.</p>
<p>Have those who have been consulted now as part of this compliance cost review expressed views on the reasonableness of the process?</p>	<p>Yes. All respondents thought that the RIA process as a whole was a useful vehicle for consultation. However, they requested that wherever possible, more time should be allowed for that consultation and that consultation should begin as early as possible. They also looked forward to the benefits of the compliance cost review programme feeding back into the process (there was concern that some other CIS RIAs could have been improved too). While accepting these comments, HMRC note that in this particular case, the change was discussed with industry in 2000, well before implementation.</p>
<p>Were compliance costs estimated for all options mentioned in the RIA?</p>	<p>No. Alternative options were not mentioned. It can be assumed, though, that the status quo would not have had any costs or savings attached.</p>
<p>Were compliance costs estimated separately for key groups (such as small businesses, large businesses, self-employed)?</p>	<p>The usual commentary was included on small businesses (quoting the number expected to be affected, but not the size of the effect).</p>
<p>Was an appropriate analytical approach used, with economists or other analysts consulted appropriately?</p>	<p>Yes, although the focus of analysis was on the cashflow benefits rather than compliance costs (the former being much greater than the latter).</p>
<p>Was there sufficient time to produce a robust assessment of compliance costs?</p>	<p>Timing was tight but not unmanageable. Consultation began early as noted.</p>
<p>Were any assumptions reasonable, given the circumstances at the time?</p>	<p>The overall assessment that costs were low was reasonable and has been borne out in practice. Some of the assumptions, although reasonable for the purposes of judging the overall cost/benefit ratio, were not stated in the RIA and could usefully have been so.</p>

Were any estimates of compliance costs caveated appropriately?	See previous answer.
Were any risks correctly identified, addressed and explained?	No risks are mentioned as regards compliance costs, but at the time there was some uncertainty as to what types of risks should have been covered in the RIA. Improvements to guidance since have addressed this problem.
Were any disagreements identified and reflected appropriately (e.g. if the figures were disputed by businesses, or if more than one set of figures was available)?	The measure was suggested by business and they supported its introduction throughout.
Would HMRC do anything differently if the exercise were repeated, and hence could the RIA process have been improved?	The change was a minor one, affecting a limited number of firms. The compliance costs were likewise low. Some of those interviewed during the research questioned whether an RIA was appropriate in such circumstances.

## **6. Learning points arising from the review**

### **6.1 Learning points for future work in this policy area**

- The review identified the risk of sub-contractors claiming credits in the wrong tax year (and potentially incurring penalties) through no fault of their own if they had encountered delays obtaining CIS vouchers from contractors. The review team is unaware of whether this can be (or has been) addressed, but has passed the research to the relevant policy staff.
- Some respondents have stated that more recent RIAs in the CIS area may have quoted inaccurate estimates of compliance costs. This is outside the scope of this particular review, but the review team has passed the information to the relevant team within HMRC.
- The review identified scope to enhance HMRC's understanding of the internal systems used by business to process CIS and payroll data. Improvements have been made in this area since the RIA was written, but there may be residual learning points in terms of RIA presentation.

### **6.2 Learning points for the RIA and compliance cost process in general**

- RIAs should state clearly what businesses will need to do in order to attain the benefits expected. If some of those activities are dependent on third parties then any risk of delay should be clearly identified. If an RIA makes assumptions about systems working efficiently then those assumptions should be stated.

- Estimates of the numbers affected can usefully be quoted in both absolute and percentage terms, where possible.
- If particular compliance costs are likely to vary between different types of business, then that should be stated, along with the factors that might influence the variation.
- The RIA was weak on what monitoring would be done. It said only that the Inland Revenue would monitor communications to judge the effectiveness of the measure in improving cashflow. With recent improvements to guidance, future RIAs will be more definitive.
- RIAs should mention alternative options, even if those options are clearly less attractive. It would be reasonable to limit the amount of analysis presented, provided that the case for the preferred option was strongly and clearly made in comparison to the alternatives.
- In this case the compliance costs were expected to be very low or even negligible. Guidance could be improved on the amount of analysis that would be proportionate in such cases. There is a balance to be struck between the risk of making a poorly informed assessment and the risk of spending a disproportionate time on an issue which may be less important than other aspects of the policy change.
- This RIA mentioned a number of consequential impacts resulting from improved cashflow. RIAs can usefully highlight such effects but should caveat them appropriately, noting that their achievement would depend on individual circumstances and are unlikely to be quantifiable.
- The RIA was presented as a measure to reduce the compliance burden, and indeed it helped business. The main benefit, the cashflow effect, was not classed as a compliance cost saving for analysis purposes. There is no right answer, but guidance could usefully be improved on whether cashflow effects are part of, or separate to, the compliance burden. HMRC notes that cashflow effects can be either a compliance benefit or a compliance cost depending on circumstances.
- The RIA stated that guidance would be provided to minimise the costs. There may be some trade-off with the help saving time and the fact that reading or accessing help does itself take time. In particular, some of those who are not affected may need to read the guidance to determine that they are indeed not affected. RIAs should flag this potential cost if it is felt to be significant: it may not be appropriate to assume that there is no impact at all on those who are “unaffected”.
- Finally, the timing of consultation and of RIAs has a huge impact on the value and accuracy of any analysis. This is known and accepted but was stressed again by those consulted. It was not a problem in this particular case.

This review has been very useful in identifying a range of issues for HMRC to address. Most of these are generic. This particular RIA covered a minor change, and the compliance costs associated with it were very small (albeit slightly higher than predicted). The review has not identified anything to suggest that this particular measure was unwarranted or disliked.

## **7. The way forward**

Comments are invited on any aspect of this report or the wider compliance cost review programme.

The learning points are being fed into the policy development process directly if particular to one RIA or policy area. More generic recommendations are being collated across the review programme overall, and will be used to create an action plan for HMRC to take forward to improve the RIA process and development.

## **8. Contact points for further information**

For issues relating to CIS policy specifically:

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**ANNEX : THE PUBLISHED REGULATORY IMPACT ASSESSMENT**