

Select Committee on Economic Affairs

Finance Bill Sub-Committee

Corrected oral evidence: Draft Finance Bill 2017

Wednesday 22 February 2017

3.35 pm

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Members present: Lord Hollick (The Chairman); Lord Bilimoria; Baroness Bowles of Berkhamsted; Baroness Drake; Lord Flight; Baroness Kingsmill; Lord Leigh of Hurley; Lord Tugendhat; Lord Turnbull; Lord Wakeham; Lord Wrigglesworth.

Evidence Session No. 4

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Questions 47 - 56

Witnesses

I: Ms Theresa Middleton, Programme Director, Making Tax Digital (Business), HM Revenue and Customs; Mr Jim Harra, Director-General, Customer Strategy and Tax Design, HM Revenue and Customs; Ms Lucy Pink, Deputy Director, Tax Administration Spending and Reform, HM Treasury.

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Examination of witnesses

Ms Theresa Middleton, Mr Jim Harra and Ms Lucy Pink.

Q47 The Chairman: Based on the evidence we have heard and on the discussions we have had with other witnesses, let us talk about some of the behavioural aspects of the introduction of making tax digital. The first thing is that most of the witnesses we have heard from, both in person and in writing, are not convinced of the benefits for their customers, their clients or their industry. Let us start off on that basis. There is considerable scepticism about how the tax gap is calculated and why it is calculated in that way. There is a sense that the behavioural response may cause people to drop out of the system, and there are questions about the extent to which that is taken into account, and that tax-motivated incorporation may see a resurgence as a result. Could you comment on some of those things? Let us start with the tax gap itself. Why are you so confident that you are right and they are all not right?

Mr Jim Harra: You are right: the prime reason for introducing making tax digital for business is to close part of the tax gap, which is mainly the small business error and carelessness gap. The last time we measured it in 2014-15, the net gap was about £5 billion. The gross gap, before deducting what we recover from our compliance activity, is about £6 billion. That is forecast to grow, in part because the number of self-employed people is growing all the time, and that is the prime population that generates that part of the tax gap. It is important that the tax gap is tackled. It has proved resistant to the existing methods of tackling it. A large proportion of small businesses employ a tax agent to help them with some of or all their tax compliance and, despite that, they continue to present as non-compliant. Similarly, we deploy a lot of resource in HMRC to try to correct errors, but, partly because of the churn in the small-business population, it does not have a long-term effect in reducing that part of the tax gap.

We believe it is right that we try to exploit the modern digital tools that are available to continue downward pressure on that part of the tax gap, and we believe it will have results. Initially, the proposals should reduce the error and failure to take reasonable care gap by about 10%, as a result of encouraging businesses to keep better records and to keep them more contemporaneously. That will reduce the error. There is also the fact that it links automatically to the filing they do to HMRC, so there is no transposition and calculations off record and then entry of figures on to a system. It has been reviewed and certified by the independent Office for Budget Responsibility. It regarded our estimate as a central estimate. We have obviously discounted it for a number of behavioural factors, which could well happen as a result of it, but we still believe that there would be a significant net benefit.

The Chairman: The OBR also said that the uncertainty of impact was "high".

Mr Jim Harra: Yes.

The Chairman: It is a finger in the air, but it is not far short of that.

Ms Lucy Pink: The OBR also said that it was central. It did say that uncertainty is high, but that is pretty standard for what it says about a number of HMRC operational measures, partly because the OBR perhaps has less experience of these compared with the pure policy and legislative changes. It does that for many compliance things, so we do not count that as out of the ordinary. It also means that it is paying a bit more attention to MTD. Its last update, at the time of the Autumn Statement 16, was that MTD was still on course to deliver the benefits that it had sought.

The Chairman: What about people taking avoiding action, if I can put it that way, and dropping out of the system?

Mr Jim Harra: A number of concerns have been raised. One is that businesses will move into the hidden economy in order to avoid this obligation. We have a problem with the hidden economy as part of our tax gap, and that is something we have separate measures to tackle. We do not believe that making tax digital will either help us to tackle that significantly or contribute to it significantly.

Another concern that has been raised is that people will choose to keep their income levels below the threshold. Where there are thresholds in the tax system, there is sometimes bunching of turnover around thresholds. The VAT threshold is a key example. We will obviously monitor that, but we are not convinced that businesses would deliberately keep their income below a £10,000 threshold in order to avoid the obligation to keep these records, because it is quite a low level of income. People will generally want to have income above that, and we do not believe that the obligations are onerous enough to cause them to do that.

The third concern is that people will incorporate in order to put off the day when they have to comply with making tax digital. Tax-motivated incorporation is something that we see in the tax system. You mentioned the prospect of its resurgence, but it happens today because of the tax differentials in the tax system. We think it is unlikely that people will go to the inconvenience and expense of incorporating just to gain what will be a temporary advantage by putting off the day of reckoning, but, again, that is obviously something we will monitor.

The Chairman: It has come out in earlier sessions that many companies, small and large, will feel that they need to get their accountant to help them do each quarter, because it forms part of their tax record, and everybody obviously wants to be scrupulous when they send in their tax return. If you do four a year, you incur four different costs. We were told that you do not get too much out of an accountant on that basis for less than £300. Costs are going to increase, although obviously those costs are allowable. Did you take that into account when you calculated the tax gap?

Mr Jim Harra: I will let Theresa explain in a bit more detail what we have done to arrive at the costings for business. A quarterly update is very different from a tax return. It is a different obligation. Some businesses will, I am sure, decide to get an agent to help them with it. Others may decide that the quarterly obligation is something they can meet themselves, and they do not need to employ an agent to help them with it because the figures are produced more readily from their business records than a tax computation or a set of accounts are. That is our experience, for example, with VAT; there is a lower penetration of tax agents in the VAT market than there is in the self-assessment or corporation tax market, for example.

Nevertheless, I am sure that some businesses, either initially or on an ongoing basis, will decide that they want their accountant either to produce the quarterly update or to review it before it is submitted. Obviously, accountants will charge for that service. The market will determine what they charge. We have some experience of that. We introduced real-time information for Pay As You Earn, which moved employers from having to make a return once a year to having to make a return every pay period—12 returns a year or even 52 a year. Initially, we heard concerns that people would now have to pay 12 times as much or 52 times as much to their agent. The reality is that the market could not make that fees model stick, and that is not what has happened with RTI. While there would undoubtedly be charges to support quarterly updates, we do not believe that you can draw a direct correlation between that and the annual charge for a tax return. Theresa might want to add something about how we have taken that into account.

Ms Theresa Middleton: I have a few other things to say about the impact assessment. When we produced the consultation document in the summer, we published two scenarios for our then forecast of the ongoing savings to business post transition. I will come back to transition in a minute, because we have published a figure of an average cost to each business in the year of transition. Those figures for the two scenarios were £85 million, the lower figure, and [£250] million as the higher figure.

We have done much more work on that using our standard cost model, which looks at all the obligations that a business is required to meet for its tax. A kind of time element attaches to those. How long does it take to do it? Does the business use an agent? What do we think it will look like after the transitional period, when the changes have been made? From that, we produced a figure of a net £100 million saving for this business population, which, as you know, given the population, is not a huge saving per business, but it takes account of the fact that, once the business has made the behaviour change to start keeping its records digitally, the software will do a lot of the heavy lifting for the business, which at the moment the business and/or its agent has to do at the end of the year.

Picture a not untypical business. January comes and there is an enormous quantity of paper to work through, categorise and remember what it was for. All that will be done by the software as the business goes along. The main reason there are savings post transition is linked to the fact that the obligations of the business will take less time. The transitional costs, which we have calculated at about £280 per business in the year of transition, take account of all the things you would expect: the need to learn how to use the new method when people are very happy with their old method of record-keeping; some businesses will seek more accountancy advice, so there is a cost for that; and there will be costs for some, perhaps, to purchase hardware or software if they are not eligible for free software—we have said that the smallest businesses will be eligible for free software. There is a range of costs.

Q48 Lord Tugendhat: Your submission states that your intention is to create a system whereby “tax becomes part of the rhythm of business”, yet these proposals go much further by mandating how businesses are to be run. I wonder if you could tell us whether you think it might not make more sense to align the tax administration system to the operations of the business world, rather than require businesses to organise their operations to fit your model.

Mr Jim Harra: We designed it to fit with the rhythm of how people do business because, when we did some research into the reasons why small businesses make errors in their tax, a key reason was that they see their tax administration as entirely separate from the way they run their business. They run their business and then separately, at certain times of the year, they think, “What do I need to do about my tax?”

We wanted to integrate tax compliance with the running of the business itself and, at the same time, encourage businesses that do not keep effective records, and make errors for that reason, to do so in future. They are currently under an obligation to keep records, but one of the key reasons for error is that they do not all do so. You could make a case for doing this voluntarily—that, if it really fits with the rhythm of people’s businesses, they will do it. Indeed, we very much hope that many exempt businesses will do it voluntarily because they find it beneficial and easy. However, the reality is that, in order to justify the investment in the system and get the tax gap closure, it is necessary to mandate it on businesses. We have a track record of successfully mandating online filing—for example, with corporation tax, VAT and Pay As You Earn, which businesses have coped with very well. We believe that, post the transition period, they will do the same with this.

Ms Theresa Middleton: Businesses need to plan for their tax bills. Some feedback that we have had from businesses is that the first time they know how much their tax bill will be is when their accountant tells them when they have completed their return for the year. Some of them may not have set aside the right amount of money for the bill. One of the advantages of integrating record-keeping and the digital software is that it will start to tell them as they go along how their bill is developing. That might not work so well for a seasonal business, because it earns its

profits at a particular time of the year, but, in general terms, many businesses will, for the first time, have much earlier sight of their tax bill. They will be able to pay as they go if they choose—there is no change of payment dates—but they will definitely have a chance to plan and manage their tax much more quickly and effectively than they can at the moment.

Lord Tugendhat: If you look at the House of Commons monitor, you will see that Sajid Javid is answering questions. It is an interesting example of the extent of the political problems that can arise if something that affects small businesses goes badly wrong. I cannot help feeling that the sort of rebellion he is having to deal with at the moment is the kind of storm that might break out if people run into real difficulties in meeting the requirements you are laying down. It could be said that you are trying to change the whole way in which people run their businesses, and to impose something of a straitjacket. The reaction could be very similar to that with which Mr Javid is coping at the moment.

Mr Jim Harra: We are not asking people to change how they run their business. We are asking them to keep contemporaneous records of their business activities, which they should be doing anyway. Currently, a significant number are not complying with their tax obligations because they do not do so. What we are not doing, obviously, is imposing any new tax on businesses. That is a different parallel. We are conscious of the need for effective implementation of the system, which is why we are embarking, in April, on a large-scale live trial over the course of a year, which will build up to hundreds of thousands of businesses. During the course of that trial we will learn about the experience of businesses and what kind of support they need from us.

We have committed to there being a soft landing for MTD. In the first year of transition, when we know that businesses will be incurring costs and taking time to get familiar with the system, there is no question of our taking enforcement action against them in relation to their new obligations. As a department, we have a good track record of effectively introducing new things with businesses, RTI being an example. It was a big thing for employers to take on, but they coped with it very well, and from our point of view it is having significant benefits. It is obviously something we are very much alive to.

Lord Turnbull: You said there was no new tax. I have to challenge that. Your own figures say that, by 2021, you are trying to get £625 million extra out of the sector. I think there is a figure around indicating that by one more year it will be up to £2 billion. I think you are trying to get another £1 billion out of the sector. You may think it is entirely legitimate to do it, but that is the reality, on top of the extra costs that we will no doubt come to. As regards the idea that there are no new taxes, a lot more money is definitely going from their pockets into your pockets, and you need to recognise that.

Mr Jim Harra: When I say no new taxes, what we are not doing is increasing taxation on businesses, but we are expecting them to pay the

tax that is due, and closing the tax gap involves more of them paying what is due than is the case now. We are doing it in what we believe is the most customer-friendly way—much better, we believe, than HMRC enforcement actions, both for businesses and for the public purse. Ultimately, it is for Parliament to decide what level of taxation businesses should bear. What is happening on the tax gap is that people are self-serving their own tax rate. Our job is to ensure that they pay the tax that is due.

Lord Bilimoria: I am sorry I was late and if I repeat something. To declare my interests, on top of what has already been declared, I am a qualified chartered accountant. I have built businesses and a main business from scratch, so I speak from experience, as a micro-business, a small business, a medium business and now a very large business, in dealing with returns.

I perfectly understand the point you made earlier; if people are forced to make monthly returns, they have to pay extra costs—perhaps not necessarily, because people adjust to that. Most monthly returns are linked to making a payment monthly. VAT returns are linked to making a quarterly VAT return payment. Here you are asking people to submit returns every quarter that are not linked to a payment being made in that quarter, and could be seen by business as an extra burden. People struggle anyway with running their businesses, and they would see this as purely a bureaucratic burden on themselves, when they already have enough trouble. Most businesses are just surviving.

You say that the rationale is that you are trying to encourage them to keep their books. What percentage do you think rely on professional advisers to keep their books? Your submission says, “This will reduce the £8 billion a year cost to the public purse as a result of taxpayer error or failure to take reasonable care”. Later, you say that the tax gap stands at £36 billion, which is made up of lots of factors, including “errors” and “criminal activities”. You then attribute responsibility to small businesses “for more than half” of that tax gap of £36 billion. How can you reconcile £36 billion, £18 billion, £8 billion and the burden?

Mr Jim Harra: I will pick up that point, and pass to Theresa to pick up the point about representation and the monthly or quarterly filing. We estimated the tax gap in 2014-15 to be £36 billion, which is about 6.5% of all the receipts that HMRC is responsible for collecting. Small businesses account for about 51% of that. Small businesses can manifest a range of non-compliant behaviours that make that up, from being in the hidden economy to error, from failure to take reasonable care to deliberate evasion. Although we obviously try to deploy solutions to all of those, this system just relates to the error and carelessness element.

Overall on the tax gap, we think that there is just short of £9 billion—about £8.7 billion—of error and carelessness across all taxpayers. About £5 billion of that relates to small businesses, but when you extrapolate forward, both the growth in small businesses and the growth in tax revenues, it will probably go up to about £8 billion in the next few years.

That is the scale of the error and carelessness gap that this solution is intended to reduce.

Ms Theresa Middleton: About 70% of businesses use an agent for some of or all their tax affairs, particularly for corporation tax and for the self-assessment return. Agent use is much higher there than it is for taxes that are more regular, as Jim has already mentioned. For VAT and Pay As You Earn, a higher proportion do it themselves, because they get into the rhythm of doing it, and they are therefore more confident about doing it themselves.

Behind your question, Lord Bilimoria, I think you may be getting at what the point of the quarterly update is. What is the quarterly update going to do? Is digital record-keeping on its own not enough? The combination of the two is the thing that will close the tax gap caused by error. If we only had digital record-keeping, behaviour being what we all understand it to be, a group of businesses, which might be the least likely to maintain contemporaneous records, could conclude that they could leave it for a lot longer before updating the position.

The aim is that compliant businesses should keep records as they go, and they need to show HMRC the results quarterly. The software will produce that for the business; it is not something that they have to sit down and do themselves if they have been keeping their records as they go along. It effectively allows them to show us where they have got to, and to demonstrate that they have been doing their quarterly updating. It does more than that; it allows them, as I have already mentioned, to get a sense of how their tax bill is evolving and it helps them to plan and manage their cash flow. Over time, we hope to use some of that information to do more of what we call nudges and prompts to help the business get things right further. We are starting with digital record-keeping and quarterly updating, but we would like to build further on that, so that when the quarterly update comes over we can help the business further in reducing error. There is a range of different factors that, together, mean that the quarterly update and the digital record-keeping together reduce the tax gap.

Lord Wakeham: What view will HMRC take of the quarterly returns, as to whether they are right or wrong or whether there are special circumstances that need explaining? What judgment will be made, quarterly, on those returns?

Ms Theresa Middleton: There is no inquiry regime around the quarterly return. The tax system remains annual for the purposes of customers in scope for income tax self-assessment. We are not changing any of the ways in which HMRC inquires into the information that the taxpayer sends us. The only penalty regime around the quarterly update will be a late-filing one, and we will consult again in the spring on what we think is the right way for that to work.

We want to encourage the small businessperson to do their best to get their records in good order and to send us an update that is as good as it

can be, but we are not going to inquire into those updates, nor issue penalties for updates not being right. It is really about helping the business to be in a better position, by the time it gets to do its end-of-year activity, to do that activity in a much easier, more straightforward, less time-consuming way.

Lord Wakeham: If a businessman is filing these things on a quarterly basis and is doing the best he can, and he discovers, in the early part of the next quarter, that he put in something that he should not have put in, or missed something out, does he just put it right in the next quarter, or does he refile the previous quarter?

Ms Theresa Middleton: He can just put it right in the next quarter, with no penalty.

Q49 **Baroness Drake:** I will return to the tax gap. In his opening comments, Lord Hollick referred to the high degree of uncertainty that the OBR attached to the figures. I have two questions following from that. First, what is the Treasury's current view of the robustness of the estimates of the tax gap effects of introducing MTD? What is your view on how robust those figures are? Secondly, will the OBR be asked to carry out a detailed examination of the figures—the revised estimates—trialled in January?

Ms Lucy Pink: We think they are robust, and we think that because as part of the costing approach of the ultimate yield that we scored, and the OBR scored, we went through, with HMRC and with the independent OBR, a series of challenges and scrutiny of the figures, and indeed of the tax base that we start with and all the assumptions that are made. Jim talked a bit about some of the different assumptions of behaviours that people will adopt one way or another.

Each of those assumptions was scrutinised, and the OBR eventually signed them off. The Budget Responsibility Committee that heads up the independent OBR signed those off as central. We stand by those. I commented before about what was said about the uncertainty; we think that is completely normal and in keeping with operational measures and the OBR's approach to them. You asked whether the OBR will be monitoring that. In annexe A to its report at every fiscal event, it provides updates on measures that it is monitoring indicating whether the yield that was forecast is coming in and whether policies or programmes are on track. As I said, it has already reported at the Autumn Statement that the progress of MTD was on track. I imagine and believe that it will continue to report on that.

Baroness Drake: The Treasury obviously wants to push ahead with the April 2018 date. To what extent is the imperative to score an estimated tax gap reduction? Is that the imperative driving the timetable, even if there is a trade-off against project implementation best practice? Life is always trade-offs. Secondly, why is April 2018 so crucial?

Ms Lucy Pink: The Treasury is interested in closing the tax gap. It is a core part of what we want HMRC to do across a range of behaviours. It is

important, when we invest in departments, in this case HMRC, that we see benefits from our investment. In this case, it is reductions in the tax gap and scorable tax yields in. That is something we looked for and asked to have.

You asked about the timetable and implementation. It is in no Minister's interest to sign off a programme that is not deliverable or is too ambitious in its timescale. Our advice to Ministers was that this was deliverable. Indeed, the IPA, the Infrastructure and Projects Authority—it was then the Major Projects Authority—was called in to scrutinise the delivery and the timetable. It assured us that it was deliverable. We do not want to sign up to a scorable yield and a profile that ultimately does not come in because of delays in delivery, as that will then show up on our forecast. That is where we ended up.

Baroness Drake: There will be £1 billion of transitional costs on business. It is a system that is currently untested. You have obviously done your modelling, and you have worked out your assumptions, but there is still a high level of uncertainty around the tax gap receipts. Can you put clearly to us what the justification is for pushing ahead with April 2018 and putting on £1 billion of transitional costs? What is the justification?

Mr Jim Harra: The transitional costs are spread over time. We start with several hundred thousand businesses that we expect will voluntarily join a year early, in 2017-18. Then, in 2018, the mandatory transitional costs kick in for the income tax self-assessment cases. The VAT cases are later, and the corporation tax cases are later than that. It is phased over a period of time; it does not all come in at the same time.

As Lucy mentioned, the phraseology that the OBR used is perfectly correct, but it is also what we are used to in relation to operational changes of this nature. It in no way signifies something that may not deliver at all. We have made some assumptions, and we have a central estimate of how much benefit it delivers. Perhaps it will deliver more; perhaps it will deliver less, but that is the best estimate as we start out.

Our belief is that we can not only deliver benefits now from what is in making tax digital but, as Theresa mentioned, that we can build on it in the future to provide more services to small businesses, so that we can help them during the year, as Lord Wakeham mentioned, to identify areas they might want to check before they do their end-of-year review. We believe there is probably a second round of benefits that we and businesses can gain from it. In my view, we are walking before we run on this one.

Ms Theresa Middleton: It might be worth adding that although we are focusing, for understandable reasons, on April 2018, which is when mandation is scheduled to commence, we are starting our pilot in April coming—April 2017. We will have the course of that year to test all the relevant services: whether the software that businesses will use is user-friendly; whether there is an adequate supply of free software for

customers entitled to free software; whether it works with our systems and is secure; and whether, when we play back to them what they have sent us, we do it in a way that is meaningful to them and helps them to think about how they can set money aside for their tax.

A process will build up during that year, with more businesses joining, some of them unrepresented and some of them with an agent acting for them. By the time we get to April 2018, we will have a lot of confidence, because we will have had a full year of testing it. We are on track to be ready for the pilot in April 2017, and April 2018 is quite a long way out from there.

Baroness Drake: There are some questions coming on the pilot, so I will not anticipate those.

Lord Turnbull: I am trying to find the answer to two questions, so far unsuccessfully, from the material that you sent. It is very strong on words and not very strong on numbers. First, what is the number of businesses below the £83,000 VAT threshold? What is the population that we are dealing with there?

Ms Theresa Middleton: I think it is 3.1 million businesses below £83,000 and above £10,000.

Mr Jim Harra: Yes. We know that just over 2 million businesses are registered for VAT. The majority of those will be over the VAT threshold; there are some businesses that choose to register below the VAT threshold. We expect that there are about 3 million below that figure.

Lord Turnbull: That is very similar to the Federation of Small Businesses' figure. Of the £625 million in closing the tax gap, what percentage is coming from the population below the £83,000 threshold? In other words, if you started at £83,000, what would you not be getting?

Mr Jim Harra: With our tax gap analysis, we can identify, for example, self-assessment income tax receipts by turnover band. About 80% of the error and failure to take reasonable care gap is in businesses with turnover of less than £83,000. That is what is at stake in that population as regards income tax benefits. Overall, the £945 million of additional revenues in the spending review period covers not just income tax; it covers VAT and corporation tax as well. That VAT is largely from businesses above that threshold, but the population below the £83,000 threshold still represents a significant chunk of those benefits—probably about a third.

Lord Turnbull: Say, £400 million. From the evidence we have heard, alarm bells are going off about this whole project. I think the reason is that, wherever you have had a choice, you have gone for the hardest line. You chose mandation, with very little option. You set a threshold at what people think is an incredibly low number. You imposed quarterly reporting. You started at the bottom, whereas in most other initiatives, such as RTI and pension enrolment, you started at the top and then

worked down. The question for you to answer when we get back from voting is, what is wrong with taking £83,000 as the starting point, exempting below that, and then over the next five years gradually bringing in more and more people? Why take it all the way down to £10,000?

The Chairman: You now have five minutes to think of the answer. We will be back shortly.

The Committee suspended for a Division in the House.

The Chairman: We will recommence. I think you can remember the question. Hopefully everybody else can.

Baroness Kingsmill: I did not hear it, because the Division Bell was ringing.

The Chairman: Do you want to give us a 30-second summary of it, Lord Turnbull, so that those who could not hear because of the bell can now hear it?

Lord Turnbull: A proposition commonly put to us was that, instead of starting with full mandation right at the bottom, we should start at the VAT limit, and that is where the mandation stops. People opt in, but over time. It could be five years, and you gradually bring it down and extend the mandation. What is wrong with that approach, which is universally, or very widely, supported?

Mr Jim Harra: There is no doubt that the higher the turnover level, the greater the existing penetration of accounting software. We would support that view. However, all our evidence on the tax gap shows that the businesses that have the greatest need of help to get their tax right, and which the greatest level of Exchequer benefits come from, are the smaller businesses. As I mentioned, those with a turnover below £83,000 represent 80% of the error and failure to take reasonable care gap in self-assessment. The Government have already announced an exemption. You mentioned the £10,000 figure, and we had strong representations in the consultation that that needed to be higher. The £10,000 level takes about 2.6 million businesses out of making tax digital, which some people probably think is a surprisingly large number. That is because there are a very large number of micro-businesses or businesses used as a second income that would be taken out by that exemption, although we hope that many of them will nevertheless voluntarily use apps and software and take advantage of quarterly updates.

Beyond that, the Government consulted on deferral and on what the criteria for a deferral should be. We received a large number of responses, many of which suggested that the £83,000 VAT threshold would be a point at which to land, although there were other suggestions. The Government are still considering that, and they will make their decision and announce it before the legislation is laid.

In the live trial, which starts in April, we are ensuring that we get a good representative group of businesses, both at the smaller end and up the income scale, to test what the transitional journey is for them. I suspect we will find that it is not just a clean correlation between turnover and how easy or difficult people find it to make the transition. I suspect that many businesses at the smaller end, particularly newer ones, will be using apps already, and they may be more technically enabled than some in the middle range, but we will find that out during the trial.

Lord Turnbull: Do you not think that, if they need more help, they also need more time?

Mr Jim Harra: We believe we have left sufficient time for businesses to make the transition, often with the support of tax agents. One of the things we are engaging with the tax agent profession on is what their one-off role is during this period, as opposed to their ongoing role, in helping their clients to make the transition to keeping digital records. We have already discussed the setting of that timeline, and we believe it is deliverable.

There have been many representations asking for more time. Not much evidence has been provided to us about what people would do with the increased elapse time if it was granted—what the activities would be during a longer period, as opposed to people putting off the time when they take action. We believe that we have enough time. Again, that is something we will test during the trial.

Baroness Bowles of Berkhamsted: I am totally confused about when you think these businesses are going to prepare themselves. You are doing a pilot starting in the next tax year. I do not know who is in the pilot. You get to play and test and practice, and then as soon as you have done that for a year, so you know how horrid it is at the year end, you will forthwith expect everybody to be able to get an app and start to learn and, presumably within three months, file their first quarterly update. Is that not a bit unfair? You, the experts, will have had a year-plus to practise, but the business does not get very long at all.

Mr Jim Harra: Theresa is the programme director, so I will let her pick up the points about what we will doing during the trial period and what parallel activity will be going on to get businesses ready.

Ms Theresa Middleton: The pilot is not just a pilot for HMRC, for us to test our systems. We are working with the software industry, through the professional bodies, with agents and a range of bodies that represent businesses, to recruit people to the pilot who, as I think Jim has already said, represent the full range of business sizes, shapes, digital capability, attitude, aptitude, et cetera. For example, we have already assigned some record-keeping software to a group of businesses that volunteered to be very early adopters. They are businesses that have never used anything like that. We understand that that group has the furthest distance to travel as regards the new requirements.

Baroness Bowles of Berkhamsted: How many of them?

Ms Theresa Middleton: At the moment, 90 are using record-keeping software, but that is ahead of the trial starting. The trial will start properly in April. We will start slowly and ramp up only when we are sure that everything is working. We will be testing customers using the new software, keeping their records, producing the update and sending the data to HMRC. HMRC plays back to them what it tells us about their tax and how their tax bill is developing over the course of the year, offering them the opportunity to pay as they go, if they wish—it is entirely optional—prompting them if they forget their update and then doing end-of-year activity once the tax year is completed.

We will test during that 12-month period, and we will be working with up to several hundred thousand businesses, as Jim mentioned. It is not just a tiny group testing whether our systems are working and all the plumbing is working with the software. The main aim of the trial is to test that the software is user-friendly, works for the small business customer and allows them to do easily what we are asking of them, so that they can feel confident. They can share their data with their agent if they choose. Some of them will no doubt want to show the agent everything; others may feel that they can do it for themselves. By the time we get to April 2018, we will have a much greater understanding of how all that is working. I do not doubt that we will find things during that time that we want to change and improve. We will get a lot more feedback from the users of those products. By April 2018, we should have much more confidence that what we are going to embark upon for a bigger group has been thoroughly tested.

Baroness Bowles of Berkhamsted: It is very different loading up a few hundred thousand to an app from loading up many millions. I do not know how many apps there are going to be. I have been practising. I warn you; there will be emails sent to you. Having somebody people can contact and question is fine when there are just a few hundred thousand joining up, but not when there are millions who cannot find out how to get to the bit so that they can email it instead of scanning it, because it is hidden by all the adverts saying “Upgrade to our premium service” and things like that. They will not necessarily be able to respond to millions of people, especially the non-app users, to say, “Sorry you were blindsided by the advert, but if you swipe across you can get to something else”. I use apps, and I was still wondering, “Hang on, where is this thing they say is there?”

Ms Theresa Middleton: At the moment, there is not a product that does that. Those products will be ready for April. If anyone has been searching for such a product, they will not find one today.

Baroness Bowles of Berkhamsted: There are a few names on the HMRC website.

Ms Theresa Middleton: There are existing record-keeping applications that are free to use, which we have listed for a long time, because we

have wanted businesses to improve their record-keeping for many years, and that was one of the ways we attempted to encourage it. From April, there will be a range of applications, probably a small number to start with. There might be an app that people can download on a smartphone. There might be a desktop application or something they can use on a tablet that will allow them to do the full journey, not just keeping records digitally, which they can do now. The app will generate the quarterly update, which is the big time saving for the small business. People can share it with their agent or not, according to what they wish.

You are quite right to say that a pilot with a few hundred thousand people involved is on a different scale from full mandation in April 2018. That is why we want to test everything thoroughly, not just whether the data flows and whether we play back the right result to the business. Does it all flow round our systems? Can we account for it properly? Can we audit what the business has sent us? Really importantly, the customer support model is one of the things we want to test during this period. It will not only be HMRC supporting customers through the process. We know already that many small businesses see their agent as the person they trust most. They trust their agent more than they trust HMRC and more than they trust their software supplier, so we expect that agents will be an important source of support and advice. One of our challenges is to help agents to provide that and to get agents using as much of our help and support as possible.

We want to embed in the software that is being produced by the industry as much help, prompts and advice as possible. Industry has a lot of appetite to use some of our materials. We already have quite a rich digital help and support offering, which is very popular with small businesses. More than 1 million of them accessed it last year. It involves things like YouTube videos, webinars and online guidance. We are keen to embed as much of that as we can in the software so that, if a small business needs help, there are a number of different places where it can get help. By the time we get to April 2018, we should have the support model fully tested.

Q50 **Baroness Kingsmill:** We are not Luddites. We support, in general terms, the digitalisation of tax. Everything else is digitalised, and there is no reason why tax collection and recording should not be, but we are just a little concerned about some of the processes by which this seems to be going through. One concern, on which we have heard some evidence, is from those in the software industry. They said that they have found it very difficult to provide clear software, because they have not had a proper spec from you yet. Would you like to comment on that?

Ms Theresa Middleton: I think I am right in saying that you took evidence from one or two particular software suppliers. The market for software is evolving quite quickly at the moment. The rise of cloud-based accounting, the ubiquity of smartphones, tablets and devices and people's embracing of social media in the UK have all rapidly transformed that marketplace. Within that, we are seeing some established players and some new entrants with an enormously wide range of models.

Although we expect that some of the existing players may not be ready for April with their products, others will be ready. We are pretty confident that, although there will not be a full range and not every supplier will be ready for April, the worst-case scenario that we have had described is that some of the software suppliers will be ready in October. That is the latest date that anybody has told us. Yes, there are bits and pieces that they want us to iron out, and we shared much of what we call the application programming interfaces—technical jargon for how the software talks to HMRC's systems. In a few cases, there is some documentation that still needs to be provided, but, in broad terms, the worst-case scenario that we have had explained to us is October.

Baroness Kingsmill: Do you expect the software people to bear the costs of this?

Ms Theresa Middleton: As we speak, they are investing in designing and delivering new services. Of course they see an opportunity for themselves. They see a risk that they will bear the cost for the customers who are entitled to the free service, so they worry about that risk, but they also have an eye on the potential prize: how can they find a way of adding value if they have more customers? That is not necessarily on a tax base; it might be about adding value more generally to the business.

Baroness Kingsmill: Adding value is a euphemism. How do they make money out of the customer—out of customers who are obliged by HMRC to do this and probably obliged to buy software? You talk, on the one hand, about making it user-friendly and, on the other hand, about adding value, but ultimately we are giving those software operators an opportunity to make money out of captive people, who have no choice but to do this because it is imposed upon them. Given that it is a public service, and HMRC is part of the public sector, why on earth are you not just putting out a free app? I asked you this question in our preliminary conversations. It seems unbelievably unfair, and potentially exploitative.

Ms Theresa Middleton: The software industry has stepped up to the government commitment that there will be free software for the smallest businesses with the most straightforward affairs. In the response to the consultation, which we published last month, we set out in broad terms who is in scope for that. They are businesses below the VAT threshold that are not employing anybody and are using the cash basis. We have around 1 million using the cash basis at the moment, so that gives you the size or order of that. It is not just that the software is free when people start and then, when they need it, amended after a year and they are charged; the commitment is for it to be free. The industry has said that it will step up and provide a free service. Of course, it hopes, like all good businesspeople, that it will find a way of making a turn on it, but it is sticking by that commitment at the moment.

As regards HMRC entering the marketplace, HMRC has—

Baroness Kingsmill: I was not suggesting a marketplace; I was suggesting a free app.

Ms Theresa Middleton: A free app—yes, of course. The strategy that HMRC has now is to allow the software industry to provide a service, and for HMRC to step in only in places where there is a gap. Our business is tax. We are a tax authority, not a software provider, but over many years we have provided software for what you might call entry-level users—a basic service. The software industry is able to be more flexible and more responsive, and can provide a much more tailored and personalised service than HMRC could ever provide. You could imagine a scenario where we might provide an app, as you suggest, Baroness Kingsmill. We would update it once a year, and it would be one size fits all. The software industry is able to tailor its products. It can make them trade specific. There is a whole range of things that the industry can do with them that we cannot.

Baroness Kingsmill: And which people would have to pay for. My point is that HMRC is a public service, and therefore you should be making it customer-friendly in order that people can pay their tax more efficiently and in a more timely way. It suits all of us that people should do that. It seems to me that this is not something where the private sector needs to be engaged. You do not put your tax inspectors out to tender, or the people who are employed at HMRC. Why can the app not be part of the public service? It seems so wrong that this is an opportunity for the software manufacturers to put ads in the middle of the software to seek to value-add, as you put it, which you know is a euphemism. It just seems a little wrong, somehow. I am not saying that the principle of digitalisation is not great.

The Chairman: Can you give a brief answer, as we need to move on?

Mr Jim Harra: Our aim is to reduce the costs of compliance to a minimum for business, but it is for all taxpayers, including businesses, to bear the costs of complying with their tax obligations. The Government have committed that there will be free software, and we have worked with the software industry to ensure that that is provided for a large group of businesses with the simplest tax affairs.

You mentioned that it is not about stepping into the market and it is about a free app, but actually it would be HMRC stepping into the market. We believe that the best way of protecting businesses and making sure that they get a choice of low-cost products is to stimulate a market. Our experience tells us that the more we step into that market and offer free government services, the more they will not meet everyone's needs or be flexible enough, as Theresa says. That damages the market and damages the ability for new players to come in and make offerings.

The Chairman: Lord Leigh, can you move us along a little?

Q51 **Lord Leigh of Hurley:** I declare my interest as a chartered accountant and a member of the Chartered Institute of Taxation.

I want to pick up on something you mentioned. I think I understood you to say that preparing quarterly accounts will facilitate annual accounts.

For those quarterly accounts to be meaningful, particularly for tax, there will have to be accruals estimates, with things like deferral of income—not 100 pages of accounts, but basic accounts that will need quite a bit of time spent on them for them to be meaningful. I am not convinced by the argument that preparing quarterly accounts is a net saving of time.

Ms Theresa Middleton: Shall I have another go at explaining that? I do not think I did so very well. The quarterly updates are not accounts, nor are they tax returns. They are simply a record of the income and expenses of the business for that quarter. In a more sophisticated business, people might in any case be preparing management accounts on a quarterly basis, and they could be a properly adjusted set. The main group we have mostly been discussing are the smaller, unincorporated businesses below the VAT threshold, probably keeping their records on paper and not even having the rigour of the quarterly VAT return, for example. Many of them will be using the cash basis, so there is no requirement at all for them to make adjustments at the quarterly update point. It will help them with their year end if they keep their records in the software as they go along, rather than sitting down with a pile of paper in January. The information will be in the software and it will present to them what is there. If they wish to, at that point they might want to make some adjustments, but if they are operating on a cash basis they may not have any to make.

Lord Leigh of Hurley: But you would accept that for tax purposes those quarterly accounts are meaningless.

Ms Theresa Middleton: They are not required by Making Tax Digital—by the reforms that we are making. There is no requirement to produce quarterly accounts. If the business wants to produce them for its own purposes and send us the results, it can do so.

Lord Leigh of Hurley: You are saying there is no requirement for them.

Ms Theresa Middleton: Not for a quarterly account; just for an update, which is simply income and expenses for the quarter.

Lord Leigh of Hurley: I think there is a misunderstanding. I understood that there was a requirement to produce quarterly accounts.

Mr Jim Harra: To be clear, the Government have announced that businesses with a turnover up to a threshold of £150,000 will be entitled to use a simple cash basis for tax purposes, not just for the quarterly updates but for their end of year. They will not have to make adjustments if they do not wish to for accruals or deferrals. They can simply account for their tax on a cash in, cash out basis.

Lord Leigh of Hurley: The big difference is that quarterly is a completely different set of accounts from annually; for instance, quarterly you do not have the gas bill and you have taken a big deposit. Over a year, it would wash through, but quarterly you will get huge distortions.

Mr Jim Harra: Potentially for some businesses—this is something we will test during the trial—the quarterly bill of what their annual tax bill is looking like may be pretty accurate. Other businesses, such as the seasonal businesses Theresa mentioned, might think, “That is not what my end-of-year bill is going to look like”. Included in that are a large number of buy-to-let landlords. We expect that their income and outgoings would be pretty consistent over the quarters.

Lord Leigh of Hurley: But others might take huge deposits from their customers, proportionate to their business.

Mr Jim Harra: Yes.

Lord Leigh of Hurley: That would distort the quarterly accounts.

Mr Jim Harra: Potentially, but there is no bill at the end of the quarter, and there is no obligation to pay anything at the end of the quarter. We will be playing back: “You sent us your first quarter’s information. On a quarterly basis, that would point to a tax bill of £X”. If the business knows that that is not a typical quarter, it may well discount that. If it is a typical quarter and it has a regular cycle, that will build up, but it is not a tax bill—it is just us playing back to businesses: “If you are thinking of setting aside money for your tax or planning for your tax bill at the end of the year, the quarter’s information that you have just sent us indicates this kind of figure”.

Lord Leigh of Hurley: The Government are keen to encourage enterprise. Lord Bilimoria managed to start off a new business from scratch and to crack away at the difficult task of building a business. If it is apparent to you from the quarterly accounts, or from the nature of the business, that it will not be paying tax for a considerable period, as most new businesses do not, would you consider exempting it from future quarterly returns for a period of time on a self-assessment basis?

Mr Jim Harra: The current proposition is that the exemption would simply be on the basis of the level of the business’s turnover, not on the level of its profitability.

Lord Leigh of Hurley: Or anticipated profitability.

Mr Jim Harra: That is not the proposal at the moment.

Q52 **Lord Bilimoria:** I do not think this has been covered. I have two questions, which are linked. First, who is driving this whole initiative? Sometimes something is driven by the Chancellor. What is the history behind this whole initiative? Why now, and why the urgency—building on an earlier question?

Secondly, on consulting, you mentioned advisers. The Chartered Institute of Taxation, which presumably covers a huge chunk of advisers, says overwhelmingly that £83,000 should be the threshold, not £10,000. Further, it says that 87% of its members consider the £10,000 exemption to be too low; more than half of them say that it should be £20,000, 41%

of them say £50,000, and 25% say that it should be the VAT registration threshold. If you are consulting and taking the advisers into account, surely you should be listening to them—let alone the burden on businesses. Linked to that, how much work have you done to create awareness of this whole project? A lot of people are still not aware of it at all and they have to implement it within a year.

Mr Jim Harra: I think there are three parts to that question. There is the question of where this all comes from and what drives it; there is the setting of the thresholds; and there is awareness. I will let Theresa pick up on the last two.

Where it comes from is the fact that HMRC focuses on the tax gap and what is required to keep downward pressure on the tax gap. There is a particular focus on small businesses, for two reasons: as I mentioned earlier, they represent 51% of the tax gap; and the small business population is growing significantly, so the upward pressure on the tax gap is inherent in that population. In the past, HMRC has been given additional funding from the Treasury to bring in additional tax revenues and to work on the tax gap. Our approach has been to use that money to employ staff to go out and investigate more businesses.

There are a number of issues with that in relation to the small business error gap. One is that those investigations are intrusive and difficult for businesses to manage. Secondly, over time, they bring in additional tax revenues year on year, but are they actually shifting the tax gap? It feels as though we are in a management position rather than a shifting position. Thirdly, in the case of error, the amount involved in each case can be relatively small, so it is quite difficult to justify that traditional approach. HMRC looked at the opportunities the digital revolution offered to find new ways of managing the tax gap, and how we could harness the growing trend for businesses to use apps and software in their business life to help with tax compliance, too. That is where the design came from.

Ms Theresa Middleton: On thresholds and on responsiveness to feedback, the proposals have evolved since the initial announcement in the spending review 2015, Budget 2016 and the six consultations that we published last summer. During that period and between the stages of the formal consultation process, we talked to businesses and their representatives, including organisations such as the Chartered Institute of Taxation, and we listened carefully to some of the key bits of feedback they gave us.

The Chairman: There is the Division Bell again. We will hit the pause button again. We will be back.

Lord Bilimoria: I am sorry about this. We will come back as soon as we can.

The Committee suspended for a Division in the House.

The Chairman: Let us recommence. We have quite a few questions still to ask, so I should be grateful if you would keep your answers as succinct

as possible, and of course the questions, too. Starting us off with a succinct question is Lord Wakeham.

Q53 Lord Wakeham: Listening to a lot of your answers, I am full of admiration for what you are doing, but it sounds to me like mission impossible. In the tests that you do over the next year, how many people will be tested in this thing who have no idea what an app is or no idea about any of these things—who put their heads under the duvet when these things started and hoped they would go away, and who do not have a clue? You have no idea. I do not want to reminisce, but after 15 years as a Minister, when I got home and finished, I did not even know that there was such a thing as an answerphone. Do you realise how many people pay their taxes and live their lives and have never had anything to do with these computers and things? I just wonder how the great public are going to cope with all this.

Ms Theresa Middleton: You are probably aware that we have to evaluate everything we do, so we cannot just say, “We will bring in this yield”, and then carry on. As part of the evaluation process, we have in place a series of measures that will help us to test whether what we expect to happen is what happens in practice. As part of that, colleagues who work in our knowledge, analysis and intelligence section are helping us to design the trial to ensure that we get a statistically representative group. We expect that we will get a much bigger group than we need.

We need a statistically representative group that will include all sizes and shapes of business, different demographics and different types of trades and professions, using an agent, not using an agent and different models with an agent in order that we can be sure that it works for all those different types. We are not just testing it with digitally savvy people who are already using apps and Facebook; we are testing it with a full range. At the moment, we are trying to oversample the more difficult group, who keep their records only on paper, because if we can make it work for that group we will be really confident that the journey will be smooth for everybody. They are the important test group.

Lord Bilimoria: Earlier, you started to answer my question about the Chartered Institute of Taxation. If its members so overwhelmingly feel that the thresholds are not appropriate, and they are the ones who are the advisers, why is one not listening to them?

Ms Theresa Middleton: I started to talk about what we have already shaped in the consultation in response to feedback from a range of bodies. For example, when the original proposals were announced, the exemption was not £10,000 for everybody in the population; the exemption was only for people with a secondary income of £10,000. The response to that told us that we needed to go further. Although turnover and capability are not necessarily directly linked, it is a good proxy in that people at the bottom might struggle a bit more with what they are required to do. As Jim mentioned, the Government have yet to announce what the actual group to be mandated from April 2018 will be, so we cannot say today what the threshold will be. As we are at the moment, it

is the group above £10,000. Before the draft legislation is published, we will know more about that.

There are other areas where the Government have listened carefully. We have talked about the cash basis—upping the threshold for the cash basis, so that more businesses can have a simpler system; extending it to unincorporated property businesses for the first time, with a £150,000 threshold, so there will be a simpler system for them; and allowing spreadsheets to count as a digital record-keeping tool, even though people might need to wash the data through their spreadsheet with a piece of software in order to meet the other obligations. The Government have listened very carefully to a range of things, adjusting the policy as they went along, with an important decision still outstanding about the group that goes first.

Lord Bilimoria: What about the awareness aspect? That was not answered.

Ms Theresa Middleton: No, it was not. Shall I respond on awareness, Lord Chairman?

The Chairman: Yes.

Ms Theresa Middleton: There are three phases. Of course, we have had the public consultation, but in the phase we have been in, we engaged mostly with professional bodies and bodies that represent a wide range of different types of business. The next phase, which we are moving on to, is the pilot—the trial. We need to recruit people to the trial. HMRC will do some of that recruitment, some of it will be done through agents and some of it will be done through the software industry. Alongside that, we will be recruiting people more generally to the trial and ramping up awareness for the April 2018 start date. As soon as we know the group that will be mandated from April 2018, we can start to ramp up our communications and marketing.

The Chairman: Apparently, 20% of the business population you are addressing is in the construction sector. We took steps to get representatives of the construction industry to come. We contacted four of the main bodies. None of them knew about making tax digital, and those are trade bodies. The construction industry seems to be completely unaware of what you are doing. How are you going to get to those people? The trade bodies do not even know about it.

Ms Theresa Middleton: I shall pick up with the construction industry representatives after this meeting. You are quite right to chide us on that. I am surprised, but it is something we can fix quickly.

Lord Wakeham: They are not the only ones, I am sure. The question is: is it possible to do what you are trying to do? That is the bit that bugs us.

Lord Flight: Could I suggest that you at least suspend the new quarterly returns? I take it that the motive behind them is to hope that they will improve people paying their taxes, but I am not so sure that it will not do

the reverse. As you have gone to some length to point out, what is asked for in the quarterly returns is not P and L, but other series of figures, which people might confuse, thinking that they are related to their tax bill. Much more to the point, nearly everyone will have to employ accountants just to do their returns online; they will not be competent to do it themselves. You are loading them with the additional costs of that, and I think that the estimated additional costs are far too low, by a factor of at least 50%. If you load them with the costs of accountants to do quarterly returns as well, you will find very substantial resentment. I go back to the comments about small business rates.

Ms Theresa Middleton: In the UK, we have been in the vanguard of online filing; we have required businesses to file their corporation tax returns, VAT returns and payroll returns online for quite some time. We have made significant efficiencies in the past at HMRC as a result of doing that.

We found that, for their end-of-year return, businesses typically use an accountant for their corporation tax or income tax. They do it only once a year, and they want to make sure that they get it right. For the returns they do more frequently, such as their VAT or their payroll taxes, there is a much more mixed picture, with businesses choosing to do some of that for themselves. We found—

Lord Flight: It is much easier to do as a task.

Ms Theresa Middleton: It is probably more straightforward, Lord Flight, but the regularity of doing it gives them confidence that they can do it, in contrast with the end-of-year return, which they do only once a year, so they would rather have somebody else help them with it. It is not our expectation that every business will need an accountant to help it to do either its quarterly return or its end-of-year activity, in the same way that businesses do not all use one now, even though they nearly all file online.

Q54 **Lord Wrigglesworth:** Can we go back to the software and the pilot scheme that is starting? You are taking on what seems to me to be an absolutely momentous job. You are going to start this in six or eight weeks' time, yet representatives of the software industry told us in their evidence that they do not yet have the technical specifications for the software that you are asking them to provide. If that is the case, it is a very tall order for them to have it ready for the pilot scheme in April, in which you tell us 400,000 people will be selected to take part. I wonder how that is going to be achieved. How are you going to do it and how are you going to assess the outcome in such a short space of time?

Ms Theresa Middleton: There are a number of different players in the software market. The Committee heard from a few of them, and they indicated that they do not expect to be ready for April. There are others that we expect to be ready for April, and they have told us that they expect to be ready. In April, when the pilot starts, a small number will be ready. A lot more have told us that they will be ready during the subsequent months—by June. The latest date that we have been told by

a software firm that it expects to be ready is October. There will be products to start with in April. Some of the smaller providers are coming to the market and see an opportunity. Some of the more established players expect to join in a bit later in the course of the year.

Lord Wrigglesworth: There are also security aspects. Anybody who has been on the Passport Office or DVLA sites will know that there are a whole stack of lookalike sites that draw people in and often drag information from them or get them involved in a way that is extremely unhelpful, and sometimes almost fraudulent. There is a big security issue, as well as preparing the system and having it ready in time. What are you doing to include that in your specification to the software manufacturers? Baroness Kingsmill raised this point. If it is going to be done by the market, that is the sort of thing we will have.

Mr Jim Harra: You are quite right. HMRC is one of the most trusted online brands, which means that unfortunately it is one of the most attacked and spoofed sites. We have a very good record of defending our customers from that. For example, we provide a single point of contact for our customers to report spoof sites or phishing emails, and to query whether emails and texts that purport to come from us really do. We have dealt with more than 700,000 such queries this year to date.

We have introduced new technical controls. We estimate that, in 2015, about half a billion phishing emails were sent from criminals to our customers, purporting to come from HMRC. So far this year, there has been a reduction of 300 million, because of technical controls that we have already introduced. By the end of this year we expect to be able to prevent almost all those emails ever reaching our customers' inboxes. We work with the new national centre, with the software industry and with our own cybersecurity team to make sure that we are ahead of that.

We have set a specification for standards in relation to security, management and processing of data that must be built into the software products that the industry supplies—both the free ones and the paid-for ones. It is built into the technical specification or API they have to interact with. We will be publishing on our website a list of the software that integrates with HMRC's systems. The software they use must be secure and, wherever their data is stored, it has to be secure. The link with HMRC has to be secure, too.

Obviously this is not new territory for us; we have virtually 100% online filing already in the business population through a very secure system, and we are currently replacing the ID verification for that to enhance it. What is new is that businesses that previously kept their records in a physical book locked away somewhere will now need a new set of security criteria in their own software products that they can feel confident in.

Baroness Kingsmill: It is still asking outsiders—when I say outsiders, I mean outside the public sector—to manage the data of a large number of people. It will be very difficult. This is different from phishing and false

sites; it is the fact that they will have access to a lot of data, and it will give them huge opportunities. Indeed, you are inviting them to take advantage of knowing about the data in order to add value. How are you going to manage all of that? It is a high-risk thing. They can mine that data very easily and use it for their own commercial purposes at the expense of customers, who, as I said earlier, are captive.

Mr Jim Harra: Whether or not there is access to the data depends on the software product. Some software products enable businesses to keep records on their own device, and there is no sharing of data with the software provider. When the time comes to do the quarterly update, they can send the data to HMRC through our secure gateway, or, if they use a tax agent, they can send it to their tax agent to check and pass on to us.

You are right: some of the software products will involve the software provider storing businesses' data for them, for example in cloud services, which is already the case for many accounting products. As I said, we will be specifying security, management and processing of data standards for those products, and publishing guidance for businesses about how to select a product that meets their needs.

The Chairman: What guarantee can you give companies providing data and putting it on those third-party systems that that data, which is obviously sensitive data about their business, will not become available and be abused? Will you be responsible for any leakage of that information?

Mr Jim Harra: It is for the software providers to be responsible for that. They have a key interest in ensuring that clients' data is kept safe if they are a provider of data storage. Obviously, it damages their brand and their market if they do not. We will be testing their products against our systems to make sure that they can successfully communicate with each other. I said that we will be specifying security, management and processing of data standards for those products, and we will provide guidance to businesses, as will tax agents, about what kind of product meets their needs, based on whether they are or are not comfortable about someone storing their data.

The Chairman: But you will be certifying the providers of those apps so that people can use them in the knowledge that HMRC is satisfied with the security arrangements.

Mr Jim Harra: Theresa can give you more detail on that, but we will say, "Here is the range of products that have been registered with HMRC and that successfully communicate with our systems", with some other information about them that will help businesses to make the right choice for them.

Baroness Kingsmill: Will you underwrite any losses that arise as a result of the failure of those software products?

Ms Theresa Middleton: That would probably be a matter for the relevant software supplier, if there was a data loss or breach.

Regarding the choice that we want to offer, small businesses that may never have used software or an app before want to know what type of app would suit them in their business and what is available. They may want a free one, for understandable reasons. When we publish on the gov.uk site the products that have passed our standards, one of the things we want to guide people through will be the question—we have had a lot of feedback on it—about people who do not feel comfortable sharing their data in cloud-based systems, and want something on their desktop that they then send securely to HMRC, as opposed to people who are more comfortable with the data and are not so worried about what might happen to it later. There are surprisingly many, for example those who sign on to Facebook for Facebook to know everything about where they are, all their contacts and all their photos.

Of course, the software industry still has to provide customers with a sense of how their data will be used, and they still have to agree that their data can be used in whatever way the software company might ask them, but we want people to have the choice of a desktop product, where they feel fully in control of the data, versus what for some will be the convenience of a cloud-based system, where they and their agent, if they have one, can share the data at the same time.

Baroness Drake: I want to pick up an earlier point. When it was put to the panel that we had evidence from the providers that it would be a tough call to meet the Government's timetable, the response, particularly yours, Ms Middleton, was, "Well, that may be their view, but we have another group of providers who are new entrants in the market and they can meet this, and we are fairly confident". I am not sure of the implications of that. If you have a preferred group of providers that are all new entrants to the market, what does that imply about your approach?

Ms Theresa Middleton: We do not have a preferred group. All that group, new and established players, are collaborating with us—for example, drawing up the terms of security standards, et cetera. They have all had the same opportunity, and the same information has been shared with them, so that they can be ready. Obviously, it is a commercial decision and a set of choices for them. We have to be very careful about how we manage that, so that we do not advantage anyone over anybody else. Equally, we cannot move at the pace of the slowest. We have shared everything with all of them, and left it for them, according to their own operating practices, to decide when they will be ready, what type of products they will have and what their relative price points will be for different types of services. We do not have an in crowd and an out group. It simply reflects the longer time that some suppliers need, and it reflects their operating models. Some operating models are much more flexible than others in that industry.

Baroness Drake: I understand that, but as regards the confidence of

HMRC and Treasury in their own timetable, the question is how you can have confidence given what the providers are telling us. You are saying that you know there is a small group of providers that are new entrants to the market and have already committed to meeting your timetable, and you have real confidence in what they say. You have a group of software providers now, that you know of, and they must, by definition, be preferred if they are the only ones that have said they can meet it. You are relying on their assertions to give you confidence in your timetable.

Ms Theresa Middleton: We are hearing from a range. They are not all new to the market, but they are not the bigger ones. The bigger ones typically have a slightly longer lead time for delivering their products and their updates. Everybody is going to be ready for April 2018. The question is, who will be ready for the beginning of the trial in April 2017? We expect probably about half a dozen, but the others are following quite closely behind. People have said that they will be ready in May or June. October is the last date by which one of them told us that it will be ready. We have confidence that there will be sufficient products to commence the trial in April and that more people will be able to join in as more software companies deliver their products during the year.

Lord Wrigglesworth: In my experience, one of the biggest suppliers of accountancy software for small businesses is Sage. Is it included in your discussions?

Ms Theresa Middleton: Yes.

Baroness Drake: There is a contradiction. You are making an assertion about that group, your reliance on them and their readiness. It is not that those people do not want to work constructively—I do not want to put words into their mouths, and they were very positive about wanting to work constructively—but it was pretty hard evidence that it is a pretty tough call to make your timetable, and there are unknowns that they need an answer to that they do not have. It does not quite line up: their hesitation—not that they were being negative about partnership working with you—and your level of confidence that this lot is clocked, and it will be smooth running from April.

Mr Jim Harra: We put out technical specifications in January. As Theresa said, a number of software providers believe that is quite sufficient for them to get on and produce their products. The timeline that some providers, particularly the larger ones, are finding really challenging is the April 2017 timeline if they want to get in at the start of the trial. Some of them say that they cannot be ready, but others say they can. We are not hearing from any of them that they cannot be ready with their products in time for when it becomes mandatory for businesses to use the system, starting in April 2018.

Baroness Kingsmill: I think you are going to increase the tax take tremendously with the returns on those software businesses.

Mr Jim Harra: We will, however, give tax deductions to the businesses that buy those products.

Q55 **Baroness Bowles of Berkhamsted:** May I take you back to a couple of points? First, I still do not know what will count as free. Will the free apps have limits on the number of items that can be loaded up? Current ones limit you to 10 scans a month; otherwise, you have to go to a premium one. If it is doing cloud storage, you get a certain amount of memory free and then it starts to charge, so if you have to keep your whole tax records for six years or whatever and there are a lot of scans, the charges could begin to get quite big, possibly. If all that data is there, it may be secure in the sense that software providers are not going to release it to your competitors and abuse it in that way, but could they still mine it? If they see that I am buying my stationery from Staples, they might start loading up adverts from some competing stationery emporium on to my feed. Is that kind of thing going to happen?

Finally, on the desktop version where people are trying to keep control of their own data, you said that if it is on a spreadsheet it will still have to be washed through. How do you make sure that the washing through does not mean that the data is no longer retained—that who the invoices are to and that kind of thing gets told in the washing?

Ms Theresa Middleton: I will cover the free software and what it would do. It is linked to the group that is entitled to free software. As I think we said earlier, those people are below the VAT threshold and not employing, so they do not run a payroll scheme, and they use cash basis. If they meet those conditions, they are eligible for a free product that will allow them to meet the requirements; they can keep their records digitally and the product will generate updates for them, which they can then send to HMRC. It will receive back from HMRC the evolving tax position so that people can, if they wish, set money aside or even pay if they choose to, and it will do their end-of-year activity for them. That is the basic product for the people who are entitled to it.

As regards washing data from a spreadsheet through a software package, people can choose to download a package to wash it through. Having to wash it through a package does not mean that the data needs to leave the security of your desktop and go into a cloud-based system. There are different ways to do it. It is really the same answer as to the previous question about different types of systems.

On the point about mining data, we covered similar territory earlier in relation to the question about whether the person's data will be used for a range of other services. There will be choices for people. They will be able to decide whether they are comfortable having a product where their data is in the cloud. If they are, what is the deal with the software provider about how they are allowed to use their data? They still have to sign up for whatever it is. We can guide people towards the choices that might be right for them, linked to things such as how they feel about the confidentiality of their data and the capacity for sharing. At the end of the

day, the small businessperson themselves will have to choose what they feel most comfortable with based on the options.

Baroness Bowles of Berkhamsted: Will those be clear on the app, rather than it just being in standard terms and conditions? You will definitely be taken to those settings.

Ms Theresa Middleton: Our plan is to put on GOV.UK the list of products, which will grow quite quickly over the course of the next few months, that meet the requirements we have set, so they will work with our systems, meet our security standards and satisfy questions about cloud-based versus desktop and how people feel about different sorts of things, such as an app versus a piece of software or using a tablet versus a desktop computer. Different types of business might be more suitable for different types of application. Some of the applications on the market at the moment are very much designed for people who are on the move, so they major on, "Take a photograph of your receipt before you lose it". Others do not do that. Our aim is to give people as much information as possible to help inform their choice.

The Chairman: What evidence do you have that introducing digital accounting for all those companies will reduce the error rate? Presumably you have done some tests on that. What is the result of those tests?

Ms Theresa Middleton: Jim was speaking earlier about how the tax gap methodology works and how to derive the figure, that is the—

The Chairman: Is it derived information, or did you actually do a real live test with 1,000 users?

Ms Theresa Middleton: We derived the figure from the work analysing the random inquiry programme. Those are cases that are picked randomly, so the incidence of errors should be at the population level. As regards testing what would happen if you introduced the measures that we are proposing, we had two teams of tax experts, who have years of experience working in this space, looking at the range of errors that were there and asking whether those errors lent themselves to being reduced by these proposals.

The Chairman: I understand that. A more conventional way of launching a new product is to have a relatively small controlled sample that you try the product out on. That enables you to see whether there is indeed some evidence that it does things, how much it costs, what the value of the data is and what the utility of all the software tools is. Only then and only after it has been exhaustively reviewed and the users' views have been taken into account—so that you can establish whether it is expensive to respond to or not—would you have the courage, if I may say, to roll out something on such a vast scale.

You seem, on the basis of derived information and modelling, not proper testing, to want to launch this to 400,000 people, and, even before you draw breath to see what the result is from those 400,000 people, you are

going to launch it to everybody. By the way, many of the 400,000 will not have completed a full year's cycle, which is the only way of evaluating whether this works or not, because it is only then that they will have filled in the tax form. It seems to be a headlong rush without actual hard evidence. I cannot think of a commercial organisation that would have the courage to do that.

Mr Jim Harra: There is a strong evidence base for the base cost of the error and failure to take reasonable care tax gap, and the behaviours that drive it.

The Chairman: But that is all derived modelling, rather than real-life testing.

Mr Jim Harra: It is from real-life cases. Every year we run a randomly selected sample of cases.

The Chairman: I am sorry to interrupt. The people you are running it against, the random sample, are not using the app that you are proposing to launch.

Mr Jim Harra: That is correct. It was about identifying that the gap is there and the behaviours that generate it. We also have some evidence from the introduction of real-time information for Pay As You Earn, where we have seen a significant fall in the gap in the first full year of operation. Putting in standards that say, "You must keep these records and transmit data to us periodically" has driven an improvement in that gap. We have that piece of evidence. Then, as Theresa said, taking real cases, we ran them through some modelling, using two panels to identify what the impacts will be. There is a challenge in testing the system, because we have to stimulate a software market to produce products that will deliver what we need, and those products currently do not exist. There is nothing to enable us to do the hard test that you suggested.

The Chairman: By April you will be rolling it out, so you will have those products. Would it not be sensible to take your time and test it thoroughly with, say, 10,000 or 20,000 users—a cross-section of all the population you are talking about? You can then see its impact and its utility. You will get real live data back. You do not have to use modelling or derived information, and you can hear from users how easy it is to use and the benefits that you think they will get from it. You will have a lot of hard facts, as opposed to derived and, dare I say, modelled facts. That will enable you to consider a rollout with the confidence that the software tools you are backing and that have your endorsement will actually work and do the job. Then, instead of having constant squabbles with industry participants, who say, "This is not going to save this. It is not going to do this. It is going to cost more", you will actually have some hard facts to have a debate about. Would that not be a more sensible way to proceed?

Mr Jim Harra: We have to take adequate time to make sure that we implement this properly and that it generates the benefits we want. We have done the right work to establish our confidence in the case for doing

it and the capability of doing it. We will have a large-scale, live trial over the course of a year, which will enable us to learn a lot before it comes in fully. Our view is that it is an adequate timescale and an adequate trial to enable us to mandate successfully.

Ms Theresa Middleton: Although, as we have heard, there is £8 billion of error and failure to take reasonable care to go after in this territory, the amount tackled by these proposals is about 10% of that. They are largely straightforward things, which you do not necessarily need large-scale behavioural trials to establish—for example, simple arithmetical errors. The software designs out arithmetical errors. Using the data in the software to produce updates and the end-of-year activity reduces transposition errors. They sound quite basic, but a lot of businesses in this space are making those basic errors and, at a stroke, the software can design them out.

The Chairman: You are offering them four opportunities. You are offering me, as a small business, four opportunities to make those errors instead of one. I am not sure that I am convinced that that is going to reduce the error rate.

Lord Turnbull: Some will go in your favour and some the other way. Unless people are deliberately putting in the lowest figure that will not attract the attention of the inspector—as I suspect happens—I cannot see that resolving the errors of transposition, for example, and simple addition errors, will necessarily be a net benefit to you.

Mr Jim Harra: Clearly, errors go both ways, and both our tax gap figure and the benefits of these measures are on the net error, not on the gross. Our evidence from the random samples that we do every year is that the balance of error is greater in terms of loss of tax than people not claiming enough relief or deducting enough expenses, for example, which is what you would expect, because generally the turnover of profitable businesses is greater than their expenses. We have plenty of sound evidence that the net effect of error tends to create a tax gap. We believe that we have identified, through our work, key ways, in which we have a high level of confidence, that this solution can help—it is not the only solution, as it only helps to some extent—and that we have a very large-scale long trial that will enable us to learn from that and implement it successfully.

The Chairman: How will you respond if many taxpayers fail to make the transition?

Mr Jim Harra: The aim, obviously, is for that not to happen. We want to be confident, as the trial goes on, as we bring on board businesses from a wide range of sectors and capabilities, that we have done enough, both in the software products that the industry has produced and in the service support that we, tax agents and software providers give, to enable businesses to do that transition. We also plan, as I said before, to have a soft landing in the first year of mandation so that, if businesses

find it difficult to make the transition, they do not have to fear being penalised for finding it difficult. We have pitched things at that level.

Q56 The Chairman: Finally, to be clear, how much will it cost HMRC to ready itself for this and to endorse and continually review the software? What will be the initial cost and the annual running cost?

Mr Jim Harra: Theresa's programme cost is £227 million, which is part of the £1.3 billion that the Government invested in HMRC in the spending review.

Ms Theresa Middleton: The main running cost will be in the support model, which we will work up in much more detail during the trial period. I cannot give you a cost for the support model, but we already provide a support model for businesses, so it will not be a whole new additional cost. It will be what more they need particularly to transition.

Mr Jim Harra: HMRC expects overall in steady state that this will make very little difference to our departmental costs.

Lord Leigh of Hurley: You will have five times as much data. There is no point having the data unless you spend time looking at it. What is the cost of the five times amount of data that you will have?

Mr Jim Harra: I do not have a figure for how much it costs us to store it.

Lord Leigh of Hurley: Using it, not storing it.

Mr Jim Harra: The key use is that our systems will produce from the quarterly update a quarterly playback to the business: "You have provided us with this information. This is what that information, added to your previous quarterly updates"—if it is during the course of the tax year—"tell us about the build of your likely tax bill". It is that sort of IT service.

Lord Leigh of Hurley: You are not using the data to communicate further with the taxpayer.

Mr Jim Harra: Not initially under these proposals. It is simply to get people to keep their records digitally and update us quarterly to confirm that they are doing that, and then our systems play back to them what we hope will be helpful information based on what they provided. As Theresa mentioned earlier, we expect that in the future we will be able to build on that to offer further services to businesses to help them get their tax affairs right, but we expect the software and our systems to do that; we do not expect to be deploying large numbers of people to do it.

Lord Leigh of Hurley: What are you telling them that they do not already know?

Mr Jim Harra: The key thing that we heard in our consultation that businesses do not know is what tax bill to expect at the end of the year. We get a lot of feedback from small businesses and their agents about the surprise that the tax bill poses to them at the end of the year and the

difficulty they have in understanding what they need to budget for to meet that tax bill. We believe that, for many businesses, but by no means all of them, our playback on a quarterly basis will help them to get a better understanding of their likely tax bill at the end of the year and will give them the opportunity to budget for that or, if they wish, to pay as they go on a voluntary basis.

Lord Leigh of Hurley: If I said to you, "I am a sophisticated businessman, I have started up my business and I can work out my own tax. I don't need you to tell me what it is, because I know", would you then back off?

Mr Jim Harra: We expect all businesses to comply. In the small business population, as you would expect, some businesses are keeping excellent, copperplate paper records and making no errors, from which we will get no benefit, but the fact is that there is £8 billion-worth of error and failure to take reasonable care in this population, and it is spread over quite a large proportion of them. Our last random inquiry programme demonstrated that 31% of small businesses were getting their tax wrong in some way.

The Chairman: You are making the point that gathering this information on a quarterly basis will give you the opportunity to have, from your point of view, a helpful conversation with the taxpayer. There are 3 million of them. How on earth are you going to get the resources to have that helpful conversation?

Mr Jim Harra: We would not expect, in that model, that the conversations would be person to person. We expect, over time, to build more sophistication into the software, to alert taxpayers either to risks in what they are presenting to the tax authority, which they may wish to look at and fix before their end-of-year activity, or to opportunities in the tax system that they may not have taken advantage of; for example, something they enter in their records could trigger the fact that they might be entitled to a relief and point them to some support that they can use. Our intention is that, with the software industry and our own systems, we would systematise that.

The Chairman: How is it going to benefit a business that at the moment only has to think about its tax bill once a year to have continuing dialogue with HMRC four times a year, when it is trying to get its product or service right, run its business and collect money? Are not those the more important priorities?

Mr Jim Harra: They are all important priorities. As a tax authority, we want businesses to be profitable. It is also an important priority to get your tax right. Unfortunately, the position we are in and have been in for many years is that many small businesses find that difficult to do, and we need to find a way to help them do it better.

Lord Leigh of Hurley: The point that was unanswered is what the cost will be of running your review and running the relationship with quarterly

tax.

Mr Jim Harra: I do not have to hand—I do not know whether Theresa has it—the ongoing running cost of the new IT. As regards additional costs for us, there is more data coming into HMRC and we need systems that play back on the quarterly update. On the other hand, there are existing systems that we will be able to decommission as a result of this measure. Our view is that, in steady state, it will generate a very modest saving for HMRC of about £3 million a year. In practice, it is not being done to generate cost efficiencies in the department; it is being done to reduce the tax gap. We do not expect the cost or saving in HMRC to be material. Lucy would want it if it was, but it is not there.

Lord Leigh of Hurley: I am sorry, but I think you missed the point. When a taxpayer receives a quarterly email from you saying, “I think you owe us £100,000”, and they thought it would be only £1,000, the first thing they will want to do is call you. You must have assessed how many extra phone calls you will have to field, and the cost thereof.

Mr Jim Harra: That is the support model that we are going to test during the trial. Our aim is that, whenever a taxpayer needs help, either because they need help to understand how to enter something in their records when making their quarterly update, or because something was played back that they want to understand, as far as possible we want the software, the online support and our YouTube videos, et cetera, to help with that, and, ideally, not contact person to person, but we will have to test that during the trial.

Lord Leigh of Hurley: That is what drives taxpayers mad.

The Chairman: One of the things you might consider doing is alerting MPs. I think that this could well lead to a great deal of anxiety and concern among small businesses, and they will inevitably get in touch with their MP, as they are doing on business rates, to which Lord Tugendhat referred earlier. Part of your outreach is to sensitise MPs, and obviously the Treasury and the relevant Minister, that this could potentially be quite a big issue for companies.

Mr Jim Harra: I will let Theresa describe the engagement we have already had.

Ms Theresa Middleton: The Financial Secretary to the Treasury, Jane Ellison MP, has written a number of round-robin letters to her colleagues, alerting them to the various stages of the consultation. We have had a number of sessions in the House of Commons Library. We have had a Westminster Hall debate. I believe that we are invited to the Treasury Select Committee after the Recess. There is also the parliamentary scrutiny that the Finance Bill will receive as it goes through the House.

I absolutely agree. Some MPs are already getting letters from some of their small business constituents, who have heard about the changes and fear that it is four sets of quarterly accounts, rather than a more

straightforward set of reforms. We will absolutely continue to build on those relationships with MPs, ensuring that they understand.

The Chairman: Finally, finally—one last question.

Lord Turnbull: It is an observation. Words such as “customer-friendly” have been used. Your own table shows that the sector will incur costs of about £1 billion over the first three years. Then it will not be until about 2030, even in cash terms, not discounted, before people get that back. Meanwhile, you are saying that you are all right; you are going to roughly break even, and it is going to cost you something net.

It is a significant cost, as the Federation of Small Businesses is telling us. That is the aggregate cost. Bigger companies or traders will make bigger savings, but the cost of getting started will be bigger for smaller people, because they are novices. As a proportion of their business, it will be much greater for smaller businesses. What I find absolutely disheartening is that you have gone through exactly the same discussions as you went through with the Treasury Select Committee a few months ago. Its members raised exactly the same points, and you have hardly moved an inch on them. I think you need to go back into the history of the Inland Revenue and the working tax credit. You need to look at the universal credit and the dangers of jumping in at the deep end, rather than starting slowly and building up. Exactly as Lord Tugendhat stated, I think you are heading for a major row with your public, and I do not see any sign that you recognise that.

Mr Jim Harra: That was indeed an observation, but I shall respond to it. First, on the costs, you are right. The prime purpose of the measure is to reduce the tax gap. It is not being done primarily to reduce admin burdens on businesses or to reduce costs in HMRC. We acknowledge that, when it comes to business costs, there is a one-off transitional cost, averaging about £280 per business, although it will be quite different within that, I suspect, for different businesses. Thereafter, there is a modest saving for businesses, but it will take about nine years to claw back the transitional cost.

I do not think we agree that the smaller the business, the bigger the burden. Whether there is a correlation between size of business and the transitional cost will vary. For example, the smallest businesses with the simplest affairs will qualify for free software. If they already have a device on which they can use that app or software, their transitional cost is their time in familiarising themselves with how to comply with their obligations. Another business may need to acquire a device, and to pay for an app or software, so it will have higher costs. I recognise that within that average there will be quite a variation, but I do not think we agree that it necessarily just goes on size.

As for listening, I feel that the consultation and engagement we have had has been the richest the department has had. Responses to the consultation from government have been to go back to the drawing board

on some things, to take longer to make up their mind about some things or to change proposals. I believe that we are listening.

On implementation, I recognise and understand that people have concerns about the timetable for delivering all this. That is the timetable, and we will start a trial in two months' time from which we will learn very quickly whether or not those concerns are things that we need to take more account of.

You mentioned some projects that we implemented in the past. Most recently, we introduced real-time information for employers, where we heard very similar concerns to those we are hearing now—the timescale is not long enough, it will not drive out benefits and businesses will not be able to cope—but, with our support, that is not what we found. That is why we are going to trial this for some time before we introduce it.

The Chairman: Thank you very much. We have to bring this session to a halt. Thank you for your attendance and thank you for staying longer than we anticipated, because of the Divisions.