FI/S4/13/13/A

The Scottish Parliament
Pàrlamaid na h-Alba

FINANCE COMMITTEE

AGENDA

13th Meeting, 2013 (Session 4)

Wednesday 1 May 2013

The Committee will meet at 9.30 am in Committee Room 6.

1. **Decision on taking business in private:** The Committee will decide whether to take items 3, 4, 5 and 6 in private.

2. **Scotland Act 2012:** The Committee will take evidence from—

   John Swinney, Cabinet Secretary for Finance, Employment and Sustainable Growth, and Alistair Brown, Deputy Director, Fiscal Responsibility Division, Scottish Government.

3. **Appointment of a budget adviser:** The Committee will further consider its approach.

4. **Land and Buildings Transaction Tax (Scotland) Bill:** The Committee will consider its approach to the Bill at Stage 2.

5. **Regulatory Reform (Scotland) Bill:** The Committee will consider its approach to the Financial Memorandum.

6. **Proposed Contingent Liability:** The Committee will consider its approach to a proposed Contingent Liability.

James Johnston
Clerk to the Finance Committee
Room T3.60
The Scottish Parliament
Edinburgh
Tel: 0131 348 5215
Email: james.johnston@scottish.parliament.uk

The papers for this meeting are as follows—

Agenda item 2

Scotland Act 2012 FI/S4/13/13/1

Agenda item 3

PRIVATE PAPER FI/S4/13/13/2 (P)

Agenda item 4

PRIVATE PAPER FI/S4/13/13/3 (P)

Agenda item 5

PRIVATE PAPER FI/S4/13/13/4 (P)

Agenda item 6

PRIVATE PAPER FI/S4/13/13/5 (P)

Finance Committee

13th meeting (Session 4), Wednesday 1 May 2013

Scotland Act 2012

Introduction

1. At its meeting on 12 December 2012 the Committee agreed to take further evidence on the implementation of the Scotland Act 2012 including on the adjustment of the block grant following the devolution of further financial powers. The Committee further agreed to submit its views on the adjustment of the block grant to the Scottish Government by the end of May 2013 in order to inform the discussions of the Joint Exchequer Committee.

2. At its meeting on 1 May the Committee will hear from the Cabinet Secretary for Finance, Employment and Sustainable Growth on the Scottish Government's first annual report on the implementation and operation of the financial provisions of the Scotland Act 2012. The report is attached along with the implementation report of the UK Government.

3. The Committee is also due to take evidence from HMRC on 8 May and from the Chief Secretary to the Treasury on 15 May.

Scottish Rate of Income Tax (SRIT)

4. The UK Government's white paper, *Strengthening Scotland's Future*[1], proposes that SRIT will be introduced in April 2016. Section 26 of the Scotland Act 2012 provides for the basic rate, higher rate and additional rate of the non-savings income of a Scottish taxpayer to be reduced by 10%. The Scottish Parliament will then levy a new SRIT which will apply equally to all of these rates. This power will supersede the existing tax varying power, the Scottish variable rate (SVR).

Deciding SRIT

5. The new Scottish rate will need to be set annually by the Scottish Parliament. The Scotland Act 2012 requires that a *Scottish rate resolution* "must be made before the start of the tax year" and that the "Standing Orders must provide that only a member of the Scottish Government may move a motion for a Scottish rate resolution." However, the white paper states that in order to allow HMRC to process the necessary administrative and compliance measures the Scottish rate "will need to be formally communicated to the UK Government by the end of December in the preceding calendar year."

[1] http://www.scotlandoffice.gov.uk/scotlandoffice/files/Scotland_Bill_Command_Paper.pdf

Transitional Period

6. Following the devolution of SRIT there will be a transitional period which is expected to be around 2 or 3 fiscal years during which the deduction in the block grant arising from the 10p reduction will be calculated annually. During this period the deduction in the size of the block grant will be based on the OBR forecast of Scottish income tax receipts for the forthcoming fiscal year. The command paper states that: "These will not be reconciled during transition and the UK Government will bear the risk of any deviation of outturn from the forecast."[2]

7. The SG states in its implementation report that: "For the first two or three years, the adjustment will be notional – the net effect of levying SRIT at 10p in the pound and deducting the block grant adjustment will be zero." However, it is not clear what the effect will be if the parliament agrees to a SRIT either above or below 10p in the pound. For example, if the parliament agrees to a rate of 11p and there is no reconciliation to outturn receipts from the forecast.

Forecasting Scottish Taxes

8. The OBR began providing forecasts of various Scottish tax receipts alongside its *Economic and fiscal outlook* (EFO) for the UK economy and the public finances in March 2012[3]. The OBR will continue to publish its forecast for these taxes alongside each EFO which is published at the time of the UK budget and each Autumn. As with the OBR's main UK forecasts these are five-year forecasts.

9. The OBR produced a methodology note in March 2012 setting out how it plans to forecast Scottish tax receipts. It states: "The OBR's role in forecasting is starting three years ahead of the initial devolution of the taxes, which will allow us to develop and improve forecasts in the light of experience and the availability of new information sources."[4] In evidence to the Finance Committee on 28 March 2012 the chairman of the OBR stated that: "We very much view the forecasts as work in progress for the time being. This is a learning experience, for us and for everybody. "[5]

10. The OBR have now published three Scottish tax forecasts. The figures for SRIT are as follows:

March 2012-SRIT

Year	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
£ million	4375	4417	4542	4874	5265	5633

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69803/Scotland_Bill_Command_Paper.pdf
[3] http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-march-2012/
[4] http://budgetresponsibility.independent.gov.uk/wordpress/docs/Forecasting-Scottish-taxes.pdf
[5] Finance Committee, 28 March 2012, OR Col. 888.

December 2012-SRIT

Year	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
£ million	4480	4462	4472	4602	4918	5242	5587

March 2013-SRIT

Year	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
£ million	4330	4240	4246	4332	4649	4976	5308

11. The OBR states that the shortfall in the forecast tax receipts for March 2013 compared with the December 2012 forecast reflects the "deterioration in the UK forecast and the Budget 2013 policy announcement that the personal allowances will reach £10,000 in 2014-15." However, they go on to state that they "still expect growth in receipts to pick up from 2014-15 onwards" on the basis of "stronger growth in average earnings and rises in employment as the economy improves."

Block Grant Adjustment Mechanism (BGAM)

12. The Committee took evidence from Professor Holtham at its meeting on 24 April. He identifies four options for adjusting the block grant:

- own-base deduction (OBD): the deduction is indexed to the assessed growth of the tax base itself;
- indexed deduction (ID): the initial deduction is indexed to an external variable such as the relevant tax base;
- proportionate deduction (PD): the grant is reduced by a given percentage so the initial reduction grows at the same rate as the grant itself;
- fixed (real) reduction (FD): the grant is reduced by an agreed sum, which may then be indexed to inflation.

13. The UK Government and the Scottish Government have set out their proposed approach to agreeing the mechanism for adjusting the block grant following the introduction of the Scottish Rate of Income Tax (SRIT) and the relevant correspondence is attached. This states that the two governments have agreed to adopt the ID methodology in developing their proposals for the BGAM. This approach to indexing would recalculate the block grant adjustment each year by indexing it to movements in the tax base at a UK level. The UK Government states that:

> "The net effect on the Scottish block as a result of adding receipts from the Scottish rate and subtracting the block grant adjustment will therefore depend on the growth in the Scottish rate tax base in Scotland (reflected in the growth in receipts) relative to growth in the Non Savings Non Dividend income tax base in the rest of the UK (reflected in the indexing of the block grant adjustment)."

14. This would mean that "a proportion of funding for Scotland would depend on relative economic performance." The Cabinet Secretary for Finance stated in evidence to the Committee on 5 September 2012 that: "the Holtham methodology links the Scottish tax base with the performance of the Scottish economy, which is a welcome and appropriate connection."[6]

15. The two governments have also identified several technical issues to work through including:

- Ensuring that the measure of indexation is based on transparent data;
- The use of forecasts and reconciliation with outturn receipts;
- Ensuring that the adjustment is transparent;
- Selection and preparation of estimates of tax base movements in advance of actual information being available;
- The thresholds and treatment of spill-over effects caused by UK income tax policy decisions;
- The number of annual adjustments.

16. It has also been agreed that the Holtham Method is not appropriate for calculating the block grant adjustment method in respect of Stamp Duty Land Tax and Landfill tax.

17. Professor Holtham states in his submission that: "Using the UK tax base as the index means domestic policies are not offset but if the UK government alters the tax base it will compensate the effect in the deduction from the block grant." While he believes that this works well for income tax "it does not work well where there are reasons to think that the UK tax base will grow at a very different rate from that of the devolved territory." He argues that it "is not in the devolved territory's interest if its own tax base is inevitably slower growing than that of the UK."

18. The budget adviser identifies a number of risks for the Scottish government as a consequence of the ID method:

- *Cyclical risk* – the risk should be relatively small;
- *UK policy risk* – the risk to SG revenues is small;
- *Scottish Policy risk* – the SG bears the risk of how its own policies impact on the Scottish income tax base;
- *Asymmetric growth* – this occurs if the Scottish economy grows more rapidly or more slowly than the UK and is intended to encourage growth-enhancing policies.

[6] http://www.scottish.parliament.uk/parliamentarybusiness/28862.aspx?r=7438&mode=pdf

19. The budget adviser also points out that there is agreement between the two governments that “indexation should be based on ‘comparable’ adjustment to the UK income tax base.” However, it is not clear what “comparable” means. When the Committee considered this issue at its meeting on 24 April there appeared to be different interpretations of its meaning among witnesses. The Budget Adviser’s interpretation is that it could be indexed against the growth in comparable income tax receipts in rUK. However, another interpretation is that it could be indexed against the growth in the level of income subject to income tax in rUK.

Parliamentary Approval

20. The Committee sought clarification from the SG in its Stage 1 report on the LBTT Bill as to whether parliamentary agreement will be required on the block grant adjustment[7]. The response confirmed that the SG will seek the agreement of the parliament on the arrangements for the block grant adjustment[8].

Borrowing

21. The Scotland Act provides Scottish Ministers with the power to borrow up to £500m cumulative current debt to address any differences between outturn receipts and forecasts. This is limited to £200m in any one year. However, witnesses pointed out that the OBR forecasts for SRIT have already been significantly revised downwards. It was suggested that there may be some questions as to whether the borrowing limit is sufficient to accommodate future forecasting errors.

Land and Buildings Transaction Tax

22. The SG has introduced a Land and Buildings Transaction Tax (Scotland) Bill[9] to replace the current UK Stamp Duty Land tax when it is devolved from April 2015. The Bill “makes provision for a tax which should be as simple as possible to understand and pay and which will place the minimum administrative burden on the taxpayer or their agent and on the tax authority.” The Scottish Government also intends to replace the current “slab” structure with a “proportional progressive structure.”

23. The Committee published its Stage 1 report on the general principles of the LBTT Bill on 27 March 2013.[10] The Committee concluded that it supports the general principles of the Bill and emphasises that it will aim to closely monitor the implementation and delivery of LBTT.

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[7] http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/61649.aspx
[8] http://www.scottish.parliament.uk/S4_FinanceCommittee/LBTT_response.pdf
[9] http://www.scottish.parliament.uk/S4_Bills/Land%20and%20Buildings%20Transaction%20Tax%20Bill/b19s4-introd.pdf
[10] http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/61649.aspx

Block Grant Adjustment

24. The Committee considered the block grant adjustment following the devolution of stamp duty during its inquiry on the LBTT Bill. Witnesses pointed out during the inquiry that while the SG intends that the financial impact of the new tax should be broadly neutral the volatility of the tax may make this difficult to achieve.

25. The most recent data for receipts for SDLT in Scotland demonstrates the extent of the volatility as follows:

Year	2007-8	2008-9	2009-10	2010-11	2011-12
£ million	565	320	250	330	275

26. Given this volatility the Cabinet Secretary stated that: "the fair and reliable way of considering the issue is to take an average of those five years and make an adjustment on that basis."[11] He also pointed out that the Scotland Bill Committee in the previous parliament "stated that it should be a one-off, non-index linked adjustment to the block grant." The UK Government has indicated that following the devolution of SDLT there will be a one-off reduction to the block grant "which will then be deducted from the block grant for all future years."[12] The Budget Adviser points out that the white paper "does not make it clear whether this reduction will be fixed in nominal or real terms." He suggests that there "is no compelling case for the use of one deflator rather than another."

27. Some witnesses also raised concerns regarding the accuracy of the OBR forecasts for SDLT receipts. The Cabinet Secretary also pointed out that the forecasts have already been significantly revised which is evident from the OBR's figures from March 2012, December 2012 and March 2013:

March 2012 - SDLT

Year	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
£ million	319	328	369	426	480	536

December 2012 – SDLT

Year	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
£ million	275	296	328	368	416	464	516

March 2013 - SDLT

Year	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
£ million	275	323	348	372	410	456	509

[11] OR Col. 2327 - 2328
[12] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69803/Scotland_Bill_Command_Paper.pdf

28. In relation to the March 2013 forecasts the OBR states that: "Although we have assumed a slower recovery in property transactions than in December, we still expect this to be the main driver behind the rise in SDLT over the forecast period."

29. The Cabinet Secretary stated in evidence to the Committee on the LBTT Bill:

> Between the March and December forecasts in 2012 that looked forward from 2012-13 onwards, the OBR reduced the estimated tax-take by 9.75 per cent, 11.1 per cent, 13.6 per cent, 13.3 per cent and 13.4 per cent. I put those numbers on the record to make the point that, given that pattern, the forward estimating of SDLT is very difficult. I therefore think that a retrospective average assessment is a much more reliable way of making the block grant adjustment. Obviously, that is a subject of discussion with the UK Government."[13]

30. The UK Government has stated that:

> Upon the passage of the Scotland Bill, the UK Government will engage with both the Scottish Government and Parliament on the means of calculating the reduction in block grant associated with the devolution of SDLT and LfT. The resulting calculations will be transparent, published and open to scrutiny or audit by external parties and based on outturn tax receipts data as well as the tax receipts forecast carried out by the independent OBR.[14]

31. The Committee states in its Stage 1 report on the LBTT Bill that:

> If the block grant adjustment was calculated within six months' time, then a five year average for the period 2010-11 to 2014-15 would need to rely on OBR forecasts for at least two, or possibly three of these years. The latest data available is for 2011-12, although 2012-13 should become available within the next 6 months. The Financial Scrutiny Unit have advised that on the basis of the currently available data and OBR forecasts, this would imply a block grant adjustment of £319.[15]

Landfill Tax

32. The Scottish Government introduced Landfill Tax Bill on 17 April[16] and the Committee has published a call for evidence at Stage 1.[17] The purpose of the Bill is to

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[13] Finance Committee, 27 February 2013, OR Col.2327-2328

[14] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69803/Scotland_Bill_Command_Paper.pdf

[15] http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/61649.aspx

[16] http://www.scottish.parliament.uk/S4_Bills/Landfill%20Tax%20Bill/b28s4-introd.pdf

[17] http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/62562.aspx

replace the UK Landfill Tax regime with legislative provisions for a Scottish Landfill Tax that will come into force the day after the UK landfill tax is dis-applied in Scotland.

33. There are no Scotland-specific figures for landfill tax revenues available from HMRC as revenue receipts are based upon reporting at a company level rather than by landfill site, and many companies operate cross the UK. The SG states in its consultation that while it is difficult to accurately forecast future revenues from landfill tax in Scotland "it is highly likely the Scottish Government's Zero Waste Plan will see both the quality and type of material landfilled in Scotland change substantially, with far less material going to landfill and what is landfilled being largely inert materials."[18]

34. The OBR forecast Scottish landfill tax receipts by assuming a constant share of UK landfill tax receipts based on an average of the last three years. It does not appear to take account of the impact of SG policy on receipts. The first three forecasts are as follows:

March 2012

£ million	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Landfill Tax	115	123	132	145	151	157

December 2012

£ million	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Landfill Tax	98	97	96	105	107	107	110

March 2013

£ million	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Landfill Tax	98	99	95	104	105	105	108

35. The OBR explain that the significant fall in forecast receipts from March 2012 to December 2012 is primarily due to a weaker UK forecast.

36. It is not clear whether the block grant adjustment following the devolution of landfill tax will be indexed and, if so, on what basis especially given that the policy intention of the tax is to reduce receipts.

Conclusion

37. The Committee is invited to consider the above issues in taking evidence from the Cabinet Secretary.

[18] http://www.scotland.gov.uk/Publications/2012/10/3524/4

Jim Johnston
Clerk to the Committee

SCOTTISH GOVERNMENT FIRST ANNUAL REPORT ON THE IMPLEMENTATION AND OPERATION OF PART 3 (FINANCIAL PROVISIONS) OF THE SCOTLAND ACT 2012

SCOTTISH GOVERNMENT FIRST ANNUAL REPORT ON THE IMPLEMENTATION AND OPERATION OF PART 3 (FINANCIAL PROVISIONS) OF THE SCOTLAND ACT 2012

Laid before the Scottish Parliament

Presented to the UK Parliament pursuant to Section 33(2)(c) of the Scotland Act 2012

April 2013

CONTENTS

<u>Foreword</u>

Under section 33 of the Scotland Act 2012 both the Scottish and UK Governments are required to report progress annually on implementing the provisions of the Scotland Act to both the Scottish and UK Parliaments. The requirement to provide such reassurance to Parliaments formed part of the agreement between the governments that allowed the Scottish Parliament to agree to a legislative consent motion for the Act in April 2012. The Scottish Government has also made clear that it will seek the Scottish Parliament's agreement to changes to Scotland's funding arrangements, now and in the future, in order to provide democratic oversight and assurance that Scotland's interests are being properly considered.

The Scottish Government believes that the interests of Scotland and the people living here will be best served by Scotland taking responsibility for all fiscal powers, including taxation and borrowing – as part of the range of powers that all independent countries exercise. This means that key decisions will be made here by those who have Scotland's best interests at heart and who have a direct stake in its success. That is the change that the people of Scotland will be able to choose when they participate in the referendum on independence on 18 September 2014.

In the meantime, the Scottish Government regards it as very important that the Parliament and people of Scotland receive a full account of our progress and that of the UK Government in implementing the provisions of the Scotland Act on their behalf. I look forward to Parliament's scrutiny of this report and that process.

JOHN SWINNEY
Cabinet Secretary for Finance, Employment and Sustainable Growth

Devolved Taxes

1. This section describes progress with implementing those powers in the Scotland Act dealing with devolved taxes. The relevant powers will be implemented from April 2015. The section reports on progress to date, and sets out plans for further activity over the period ahead. None of the relevant powers has yet been implemented, nor has there been any further devolution of taxes beyond those set out in the Act at the time of enactment, so this section does not comment on these issues. Nor does it comment on the effect of devolved tax powers on the Scottish block grant. This depends on arrangements for the block grant adjustment and is covered in that section of the report. The Scottish rate of income tax is discussed separately.

The Scottish Government's proposals

2. The Scotland Act, enacted on 1 May 2012, devolved to the Scottish Parliament power to legislate for a tax on transactions involving interests in land, and for a tax on disposals to landfill. In a statement to the Scottish Parliament on 7 June 2012, the Cabinet Secretary for Finance, Employment and Sustainable Growth indicated that the Scottish Government would bring forward for scrutiny by the Parliament legislative proposals for both devolved taxes. The Cabinet Secretary also set the direction for devolved taxes in Scotland, emphasising that the burden they imposed would be proportionate to the ability to pay and that taxes would be efficient to administer, convenient to pay, and certain in their effect. On tax collection, the Cabinet Secretary said that the Scottish Government had decided to establish a Scottish tax authority, to be called Revenue Scotland. It would work closely with Registers of Scotland to administer the devolved tax on land transactions and with the Scottish Environment Protection Agency (SEPA) on the devolved tax on landfill.

Land and Buildings Transaction Tax

3. Since then, good progress has been made. Consultation on the proposed Land and Buildings Transaction Tax (LBTT) began on 7 June 2012 and ran to 30 August. An LBTT Bill was introduced on 29 November 2012. Key features of the proposed tax include a progressive structure in place of the slab structure of Stamp Duty Land Tax which LBTT will replace; a different approach to the taxation of non-residential leases; and changes to some tax reliefs.

4. The Scottish Parliament started its Stage 1 scrutiny of the Bill in January, holding 5 oral evidence sessions with a wide range of witnesses. The debate on the Stage 1 report takes place on 25 April. The Bill is scheduled to complete its parliamentary stages by the end of June. Thereafter, subordinate legislation on a range of matters set out in the Bill will be required. Guidance on the detail of the tax, how it will operate and what this means for taxpayers and their agents will be prepared, involving Revenue Scotland and Registers of Scotland. The Scottish Government has indicated that it expects to propose tax rates and thresholds at the time of the draft

Budget for 2015-16. These will require Scottish parliamentary approval under powers set out in the LBTT Bill. The tax is expected to come into operation at the beginning of April 2015.

Scottish Landfill Tax

5. A consultation on a Scottish landfill tax began in October 2012 and concluded in January 2013. Key features included the proposal that unlicensed disposals should be subject to tax in Scotland; and that rates and structure of the tax should broadly mirror those in place under the existing UK landfill tax regime to avoid cross-border imbalance. The Government has also proposed that a Scottish landfill communities fund, payments to which would earn tax credits for landfill operators, should be established. The criteria would be consulted on further, but it is proposed that there should be a higher credit cap than under current UK arrangements.

6. The Scottish Landfill Tax Bill was introduced to the Scottish Parliament on 17 April. It will be scrutinised by the Finance Committee. Building on the consultation responses and on-going engagement with industry, the main change from the existing UK landfill tax is to include provisions that will allow unauthorised waste deposits (e.g. illegal dumping) to be taxed. The Bill is scheduled to complete its parliamentary stages by early 2014. Thereafter, subordinate legislation will be prepared under powers set out in the Bill and guidance for taxpayers will be developed, involving Revenue Scotland and SEPA. This will include information on the tax, how it will operate and what this will mean for taxpayers and their agents.

Tax Management Bill

7. The Scottish Government has indicated that it intends to introduce a Tax Management Bill addressing the administrative arrangements for all devolved taxes. A consultation document was published in December 2012, and the consultation ended on 12 April. It set out proposals for placing Revenue Scotland on a statutory basis, and conferring powers and duties on it. The proposals also cover the duties of taxpayers, arrangements for securing compliance, settling tax disputes including arrangements for handling appeals, tackling avoidance, and handling of taxpayer information. Responses to the consultation are now being considered. The Scottish Government has indicated that it intends to introduce a Bill in autumn 2013 for parliamentary scrutiny.

Revenue Scotland

8. The Cabinet Secretary set out in his statement of 7 June 2012 broad proposals for establishing Revenue Scotland. The new body will work with Registers of Scotland and SEPA to administer and secure compliance with the devolved taxes. Revenue Scotland will build on the work that these existing bodies already do in registering land transactions in Scotland and in regulating disposals to landfill. This will enable the new body to operate more efficiently and flexibly, and at lower cost than was estimated by Her Majesty's Revenue and Customs (HMRC) for the administration of the devolved taxes in Scotland assuming that they mirrored the current UK taxes. An estimate of

Revenue Scotland etc. costs was placed in the Parliament's information centre (SPICe) in June 2012.

9. As noted, the proposed Tax Management Bill will make proposals for establishing Revenue Scotland on a statutory footing, with a structure and governance arrangements reflecting the options set out in the consultation paper and any views expressed in response. In the meantime, the new body exists as an administrative entity within the Scottish Government. The Head of Revenue Scotland was identified in autumn 2012 and has been in post since 1 October. Key staff are being recruited, among them a Chief Operating Officer who has direct experience of tax administration, including the existing UK SDLT. The body will have 9 staff from June 2013. A programme of work has been established with Registers of Scotland and SEPA to oversee design and development of systems, training, guidance, structures and other arrangements to ensure that the devolved taxes can be collected efficiently and effectively from April 2015. Revenue Scotland is engaging in dialogue with taxpayers and their agents in Scotland.

10. Revenue Scotland is also working with HMRC on arrangements for "switching off" the UK taxes that will cease in Scotland from April 2015. This includes developing transitional arrangements, and work to ensure that taxpayers are properly prepared and that systems can handle the transition successfully. Costs incurred by HMRC are being met by the Scottish Government. In 2012-13, these costs amounted to £18,153. They arose from work on the SDLT switch-off project. Costs in future years will be met from the appropriate budget as described in paragraph 25 below. Initial estimates provided by HMRC indicated that part of the work involved in "switching-off" SDLT and Landfill Tax would cost in excess of £500,000. Work is underway to provide an estimate of the full amount and the results are expected in 2013.

New taxes

11. The Scotland Act also gives the UK Government power to add to the Scottish Parliament's legislative competence by devolving responsibility for further taxes, by Order, with the agreement of the Scottish and UK Parliaments. To date, no proposals have been made for this power to be used. However Ministers of the Scottish and UK Governments have discussed and agreed in outline arrangements for considering any such proposals should they be brought forward. The Scottish Government continues to press for Air Passenger Duty to be devolved to Scotland, noting that the Northern Ireland Executive has been given devolved power over aspects of APD in Northern Ireland.

Borrowing Powers

12. This section describes progress with implementing the powers in the Scotland Act dealing with borrowing. As with devolved taxes, it reports on progress to date and future plans. The relevant powers will be implemented from April 2015. There will be no effect on spending power in Scotland until then.

Capital Borrowing

13. The Scotland Act enables Scottish Ministers to borrow for capital purposes up to a cumulative maximum of £2.2 billion. HM Treasury have made clear that borrowing in any one year must not exceed 10% of the Scottish Government's capital Departmental Expenditure Limit (CDEL) which restricts annual borrowing to approximately £240 million. Borrowing may be through the UK Government from the National Loans Fund, or by way of a commercial loan (directly from a bank or other lender). The Scotland Act also gives the UK Government power to expand the range of ways in which the Scottish Government can borrow to include the issue of bonds. The UK Government has consulted on using this power but has not yet reached a decision. The Scottish Government has argued that it should have the power to issue bonds should it choose to do so.

14. The Scottish and UK Governments have discussed and agreed arrangements for capital borrowing from the National Loans Fund. In brief, the Scottish Government will be expected to provide an estimate of its expected capital borrowing from the NLF before the beginning of the year in which the borrowing will take place. Loans can then be requested in-year up to the annual limit, with approximately 5 working days' notice. Normal NLF terms will apply. This means that the Scottish Government would be able to select the type of loan (e.g. equal instalments of principle or repayment of principle at term). The term of any loan would normally be for 10 years, but where the lives of the assets being purchased through the loan justify longer or shorter terms, these can be agreed. Interest rates will be those prevailing at the time for any NLF borrower. For example, the current NLF interest rate for a 10-year loan repaid through equal instalments of principle is approximately 1.1%.

15. The Scottish Government will be responsible for setting up systems to record and repay loans. The Scottish Government will be able to apply funds borrowed in this way to any capital investment. Loans will appear in the Scottish Government's balance sheet as a liability and will be subject to audit.

16. The Scottish Government is discussing with officials of the Parliament arrangements for providing information about borrowing in the context of future draft Budgets.

17. No arrangements have yet been made in relation to borrowing by the Scottish Government by way of commercial loans from banks or other lenders.

Revenue Borrowing

18. The Scotland Act enables the Scottish Government to borrow for certain revenue purposes up to a maximum of £500m. Treasury have indicated that the limit in any one year would be £200 million. Such loans are to be repaid within 4 years. The purpose of these loans is to help smooth fluctuations in tax receipts. In particular, revenue borrowing will be available to provide bridging funding where actual tax receipts fall short of forecasts and where the alternative would be for the Scottish Government to have to reduce spending in-year. The intention is that borrowing of this kind would be available in relation to both devolved tax receipts (and therefore effective from 2015-16) and receipts from the Scottish rate of income tax following the transitional period (from 2018-19 or 2019-20).

19. The Scottish Government is discussing with HM Treasury the circumstances in which this borrowing would be accessed, and the arrangement for doing so, with a view to the arrangements being in place and available for use from 2015 onwards. Use of revenue borrowing would not, because of its nature, be planned in advance of the need arising.

Scottish Cash Reserve

20. The Command Paper "Strengthening Scotland's Future" set out proposals for a Scottish Cash Reserve. The concept is that from 2012-13 the Scottish Government can set aside funds from current budgets (and, from 2015-16, a proportion of receipts from devolved taxes) in a reserve for release in future years when particular criteria are met. This is intended to give the Scottish Government three options when receipts fall below forecast – first, to use funding from the cash reserve; second, to have recourse to revenue borrowing; and third, to cut expenditure in-year.

21. As with revenue borrowing proposals, the Scottish Government is discussing how in practice the proposed cash reserve would operate and in particular the circumstances in which funds set aside in previous years from Scotland's budget or tax receipts could be released to support current expenditure.

Scottish Rate of Income Tax

22. This section describes progress with implementing the Scottish rate of income tax (SRIT), and also comments on future plans. On present plans, SRIT powers will be implemented from April 2016. Scottish taxpayers are defined in the Scotland Act. All Scottish taxpayers will see their rate of UK income tax reduced by 10p in the pound across each income tax band. The Scottish Parliament will be able to pass a Resolution setting a Scottish rate to replace the 10p reduction. The tax will be administered by HMRC, who will therefore be responsible for setting up the necessary systems, identifying Scottish taxpayers, collecting sums due, ensuring compliance, following up unpaid tax, and reporting on performance. Revenues from SRIT will be collected by HMRC along with UK income tax receipts, but will be identified and reported separately and will form an element of the Scottish Government's budget after 2016 under the UK Government's plans. The block grant adjustment in respect of SRIT will also be applied to the Scottish budget.

23. The costs of establishing and operating SRIT are to be met by the Scottish Government. The UK Government provided an initial estimate in November 2010 when the Scotland Bill was introduced of £40 million to £45 million for set-up costs in the period to March 2016, and about £4.2 million a year in running costs thereafter.

24. One of the first tasks of the SRIT project is to develop a detailed, costed plan for the necessary work. HMRC are leading this and work is under way. The project is subject to standard HMRC governance arrangements, including external Gateway review. A Scottish Government official sits on the project board and has access to all project papers. The planning work includes identifying key decision points, and also arrangements for engaging with Scottish taxpayers and employers affected by the changes. Where decisions would have an impact on Scottish taxpayers and employers, and / or on the costs of the project and on matters of communication and engagement, HMRC will consult Scottish Government officials. Where necessary, the views of Scottish Ministers will be sought.

25. It is too early in the work of preparing the detailed plans to say whether any savings will be possible on the original broad brush cost estimates. Some initial costs have arisen in 2012-13, amounting to £165,141 in total. These have been met by the Scottish Government from the Administration budget. The Scottish Parliament has approved a budget for 2013-14 that includes £3.5 million for the costs of implementing the financial provisions in the Scotland Act. This total has been set aside to cover costs of the SRIT implementation project, costs arising from the projects to "switch off" Stamp Duty Land Tax and Landfill Tax in Scotland from April 2015, and costs incurred by RoS and SEPA in developing systems and processes relating to administration of LBTT and Scottish LfT respectively. The budget was drawn up in summer 2012 in consultation with HMRC and in the light of cost estimates provided to SPICe and reflects the best information then available on likely costs in 2013-14. HMRC have provided an updated estimate for 2013-14 costs of £1.5m across the three HMRC led projects. Provision for

costs falling in 2014-15 and beyond will be dealt with through the Scottish Government's budgeting process at the appropriate time.

26. A Memorandum of Understanding has been agreed between the Scottish Government and HMRC setting out arrangements for overseeing the necessary work on developing and operating SRIT. The MoU is published at http://www.scotland.gov.uk/Resource/0041/00417598.pdf. The Public Audit Committee and the Finance Committee of the Scottish Parliament reviewed the MoU in draft last year. In November 2012, the PAC took evidence on the draft Memorandum from the Comptroller and Auditor General and from the Second Permanent Secretary at HMRC who has been appointed Additional Accounting Officer (AAO) in respect of SRIT. The AAO has agreed to be available to give evidence when requested by the Scottish Parliament and its Committees. However he does not have a formal, statutory duty to give evidence. The PAC also took evidence from Scottish Government officials and from Audit Scotland.

27. A number of important issues relating to establishing and running SRIT were discussed by the PAC with witnesses. These included arrangements for obtaining assurance on value for money; arrangements for external audit and reporting; and the provision of performance information on the operation of SRIT including on tax collected, compliance, and service to taxpayers. Both the PAC and the Finance Committee provided comments on the draft Memorandum, and these were taken into account in agreeing the MoU, which will be kept under review as the SRIT project progresses.

28. The PAC and the Finance Committee have made clear that they wish to continue to monitor progress with establishing SRIT, including by taking evidence from witnesses from the Scottish and UK Governments. The PAC has also made clear that it will seek further comments from the National Audit Office and from Audit Scotland on audit and assurance issues. The Scottish Government is ready to provide whatever further information is requested by the Committee.

Block Grant Adjustments

29. The Command Paper "Strengthening Scotland's Future" sets out arrangements for reducing Scotland's block grant to compensate for the fact that, under the Scotland Act, receipts from devolved taxes (with effect from April 2015) and from SRIT (on present plans, from April 2016) will be added to the Scottish budget. Calculation of the Scottish budget is an administrative matter overseen by HM Treasury. Therefore the block grant adjustment arrangements are not set out in the Scotland Act. However these arrangements are important in determining Scotland's aggregate budget.

30. The block grant adjustments can be considered in two parts – the adjustment in respect of SRIT; and the adjustment in respect of the devolved taxes. As regards the adjustment in respect of SRIT, the UK Government originally described an approach in the Command Paper which caused concern to the Scottish Government. This was because of the effect that the approach would have had on the Scottish budget since 1999 had it been applied during these years. Following a discussion among Ministers at a meeting of the Joint Exchequer Committee and thereafter, it was agreed that an adjusted approach should be used. The approach (referred to as the "Holtham method") was confirmed in the exchange of letters between Scottish and UK Ministers on 20 and 21 March 2012. Officials are working on the details, including data sources. On present plans, the adjustment in respect of SRIT would be made first in 2016-17. For the first two or three years, the adjustment will be notional – the net effect of levying SRIT at 10p in the pound and deducting the block grant adjustment will be zero.

31. Turning to the block grant adjustment in respect of the devolved taxes, the Command Paper notes that "When the smaller taxes are devolved, currently planned to be April 2015, there will be a one-off reduction which will then be deducted from the block grant for all future years."

32. The Office of Budget Responsibility has estimated that in 2011-12, SDLT raised approximately £275m in Scotland and Landfill tax about £100m. The block grant adjustment will compensate for the financial effects of these tax revenues flowing directly to the Scottish Government following planned devolution of the two taxes. The calculation of this initial adjustment remains under discussion.

First Annual Report on the Implementation and Operation of Part 3 (Financial Provisions) of the Scotland Act 2012

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Presented to Parliament pursuant to Section 33(1)(b) of the Scotland Act 2012

Presented to the Scottish Parliament pursuant to Section 33(1)(c) of the Scotland Act 2012

April 2013

SG/2013/45 £10.75

Any enquiries regarding this publication should be sent to us at pressoffice@scotlandoffice.gsi.gov.uk

This publication is available for download at www.official-documents.gov.uk

This document is also available from our website at www.gov.uk/scotland-office

ISBN: 9780108512360

Printed in the UK by The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office

ID 2555011 04/13 19585 29123

Printed on paper containing 75% recycled fibre content minimum.

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FOREWORD

The Scotland Act 2012 marked a significant step forward for Scottish devolution. The Act provided the largest transfer of fiscal power from London since the creation of the United Kingdom, introducing a new Scottish rate of income tax, devolving Stamp Duty Land Tax and Landfill Tax, establishing powers to create new devolved taxes or devolve existing taxes by agreement between the two governments, and creating new borrowing powers for the Scottish Government.

These new financial powers represent a radical, historic and significant change to the financing of public services in Scotland. The Office for Budget Responsibility forecasts that these measures will enable the Scottish Government to fund around a third of the spending it controls; more than double the proportion currently funded through council tax and non-domestic rates.

The Scotland Act 2012 implemented the recommendations of the Commission on Scottish Devolution, delivering substantive reforms to the devolution settlement in Scotland on a range of financial and non-financial matters. Delivering the Act was a significant achievement; from its introduction in November 2010 through to Royal Assent in May 2012, the legislation was subject to detailed scrutiny in the UK and Scottish Parliaments and received overwhelming support from both. But as we recognised during the passage of the Bill, the legislation is just one part of the process and both governments are now focused on the practical steps required to implement these important changes.

The significant devolution of fiscal powers is set out in Part 3 of the Scotland Act. The implementation of these powers represents a substantial body of work and a timeline that stretches into 2016 and beyond to ensure that the new system operates with stability and predictability for the provision of devolved services in Scotland. In order to ensure that both parliaments are kept informed, we committed during the passage of the Bill to publish an annual report on the implementation of the financial provisions. This is the first annual report and provides an opportunity to reflect on how we have acted to implement these important changes since the Bill received Royal Assent on 1 May 2012.

The work undertaken over the last year illustrates the power of devolution, with two parliaments and two governments working together in the interests of Scotland. The new powers will give the Scottish Parliament greater control over a significant proportion of the Scottish Government Budget and how this money is raised, while transitional arrangements and new borrowing powers for Scottish Ministers ensure that the support and stability of the wider UK economy continues to apply in Scotland. With the implementation of these finance provisions, Scotland will continue to have the best of both worlds.

Rt. Hon. Michael Moore MP
Secretary of State for Scotland

CHAPTER 1

INTRODUCTION

Scope and Content of this Report

1. Part 3 of the Scotland Act 2012 deals exclusively with the devolution of financial powers. These include:
    - the creation of a new Scottish rate of income tax;
    - the disapplication of UK stamp duty land tax in Scotland and provision for the introduction of a new Scottish tax on land transactions;
    - the disapplication of UK landfill tax in Scotland and provision for the introduction of a new Scottish tax on disposals to landfill;
    - provision for borrowing by Scottish Ministers; and
    - the power to devolve further existing taxes and create new devolved taxes.

2. The financial provisions represent a substantial body of work and it is recognised that their implementation must be carefully managed over a period of time. The financial provisions will be implemented over a number of years, in line with the timetable set out in the Command Paper which accompanied the Scotland Bill in November 2010, to ensure that appropriate transitional arrangements are put in place. In order that both the UK and Scottish Parliaments are fully informed through this process, section 33 of the Scotland Act 2012 requires the Secretary of State for Scotland and Scottish Ministers to report annually on the implementation of this part of the Act.

3. Both parliaments will be sighted on the views of both administrations: the Secretary of State for Scotland is required to report to the UK Parliament and provide a copy to Scottish Ministers who are required to lay it before the Scottish Parliament; and Scottish Ministers are required to report to the Scottish Parliament and provide a copy to the Secretary of State, who is required to lay it before both Houses of Parliament at Westminster. Both governments will continue to report until April 2020, or the first anniversary of

the day on which the last provisions of Part 3 come into force, if that is after April 2020.

4. Section 33(5) of the Scotland Act requires the annual reports to contain:
   (a) a statement of the steps which have been taken, whether by the maker of the report or by others, since the making of the previous report (or, in the case of the first report, since the passing of this Act) towards the commencement of the provisions of this Part,

   (b) a statement of the steps which the maker of the report proposes should be taken, whether by the maker of the report or by others, towards the commencement of the provisions of this Part,

   (c) an assessment of the operation of the provisions of this Part which have been commenced,

   (d) an assessment of the operation of any other powers to devolve taxes to the Scottish Parliament or to change the powers of the Scottish Ministers to borrow money, and of any other changes affecting the provisions inserted or amended by this Part,

   (e) the effect of this Part on the amount of any payments made by the Secretary of State under section 64(2) of the 1998 Act (payments into the Scottish Consolidated Fund), and

   (f) *any other matters concerning the sources of revenue for the Scottish Administration (within the meaning of section 126(6) of the 1998 Act) which the maker of the report considers should be brought to the attention of the Parliament of the United Kingdom or the Scottish Parliament.*

5. Each of these areas is addressed in the relevant sections of the report. Annex A provides a detailed list of the paragraphs in the report which address each of these requirements.

CHAPTER 2

SCOTTISH RATE OF INCOME TAX

From April 2016, the main UK rates of income tax will be reduced by 10 pence in the pound for those identified as Scottish taxpayers. The Scottish Parliament will set, in its annual budget, the new Scottish rate of income tax to be added to the reduced UK rates. The Scottish block grant will be adjusted to reflect this change in funding streams.

Steps taken towards implementation

6. Implementation of the Scottish rate of income tax is led by an HMRC project with oversight provided by the programme board, made up of representatives from HMRC, HM Treasury and the Scotland Office as well as the Scottish Government.

7. The programme is responsible for the implementation of the Scottish rate of income tax as well as the disapplication of Stamp Duty Land Tax and Landfill Tax in Scotland. The Scottish Government is represented on the programme board and on the boards of projects responsible for the changes to each of the three taxes. The fully devolved taxes are discussed in greater detail in chapters 3 and 4 of this report.

8. Programme board members are involved in decision making to ensure that the projects provide effective solutions and value for money.

9. To provide a framework to support the successful implementation of the Scottish rate, HMRC and the Scottish Government have set out their respective roles and responsibilities in a Memorandum of Understanding. This agreement sets out the arrangements for the two governments to work together on the implementation of the Scottish rate, including the arrangements for the Scottish Government to meet HMRC's costs of implementation, and how HMRC will ensure that its expenditure represents value for money for the Scottish Government. UK and Scottish Ministers agreed the final text of the Memorandum in February and it has subsequently

been signed by officials. The Memorandum has also been shared with the Scottish Affairs Committee by HMRC on 14 March 2013, and Scottish parliamentary committees by the Scottish Government, and published on the HMRC and Scottish Government websites[1].

10. The Scottish rate of income tax project is responsible for three significant activities necessary for implementation:
    - Identifying Scottish taxpayers and preparing them along with employers, agents, pension providers, software developers and payroll bureaux for the introduction of the Scottish rate of income tax;
    - Enabling the administration and collection of the Scottish rate of income tax due from April 2016 through changes to the PAYE (‘pay-as-you-earn’) and Self Assessment systems – work on system changes is expected to start in 2014;
    - Developing a transparent and efficient process to account for taxes collected under the Scottish rate for the 2016-17 tax year and onwards.

11. In the first phase of the project, which began on Royal Assent and will continue during 2013, HMRC is examining UK income tax systems including PAYE, Self Assessment and Pensions, in order to establish the impact of the Scottish rate of income tax. This includes an examination of HMRC customer information and the key forms and guidance currently used to communicate with taxpayers, as well as the finance and accounting processes that would be required to account for the Scottish rate of income tax.

12. The cost for the project has been estimated at £40m-45m for implementation, including around £10m in IT costs. After implementation, the annual running costs are estimated to be £4.2m each year. HMRC has invoiced the Scottish Government for the costs associated with the implementation project in 2012-13 – a total of £165,141. HMRC has shared an estimate of costs with the

[1] The Memorandum of Understanding on the Scottish rate of income tax can be found at: http://www.hmrc.gov.uk/news/mou-sri-tax.htm

Scottish Government for the programme in 2013-14 of £1.5m which covers the cost in that year of work associated with switching off Stamp Duty Land Tax and Landfill Tax as well as implementing the Scottish rate of income tax.

13. Shortly after the Scotland Bill was introduced to Parliament in 2010, HMRC set up three technical groups to examine a number of consequential issues arising as a result of the Scottish rate – the groups looked at pensions tax relief, charitable giving and general income tax issues (for example, the taxation of income from trusts) and included representatives of the legal and accountancy professions, charities and pension providers, and representatives of employers and developers of payroll software. In discussion with these groups, HMRC developed a series of proposals for the treatment of these reliefs and types of income and, in May 2012, published a Technical Note on the HMRC website seeking comments. The respondents to this Note were content with the proposed way forward. A further document will be published in 2013 confirming the changes to be implemented and providing an opportunity for comments on draft regulations.

14. In November 2012, Edward Troup (Tax Assurance Commissioner and Second Permanent Secretary, HMRC) was appointed Additional Accounting Officer with responsibility for the Scottish rate of income tax. This role was identified in the Command Paper published with the Scotland Bill in 2010. The Additional Accounting Officer is accountable for the performance of HMRC in establishing and operating the Scottish rate and has undertaken to give evidence to committees of the Scottish Parliament on HMRC's administration of the Scottish rate when requested. On 21 November 2012, Edward Troup gave evidence to the Scottish Parliament's Public Audit Committee on the Scotland Act 2012 and he has been invited to attend the Finance Committee in May 2013.

Further steps that will be taken towards implementation

15. During 2013-14, the project will design new processes which will ensure that HMRC can accurately and efficiently collect the Scottish rate of income tax. The project will develop an approach to identifying Scottish taxpayers, based

on an examination of current HMRC data on taxpayers’ places of residence and potential additional sources of information. Work will also begin on the design of appropriate compliance processes to provide assurance that people are correctly identified as Scottish taxpayers and are paying tax at the correct rate, and on developing a communication strategy to ensure that individuals and employers affected by the implementation of the Scottish rate receive the information they need and understand their obligations. HMRC expect to make potential Scottish taxpayers aware during 2015-16.

16. As these processes are designed, estimates of the cost of the implementation project will be refined and revised as necessary. Work planned in 2013-14 will lead to a more accurate estimate of the cost of identifying Scottish taxpayers – the major element of non-IT costs for the Scottish rate project. Where there are options for the way in which implementation is designed, these will be taken through the project and programme governance, involving Scottish Government representatives. Detailed work to implement the IT systems changes required for the Scottish rate of income tax will begin in 2014 and take around two years: more accurate estimates of the cost of system changes will not be available until that work has been agreed.

17. At Budget 2013, the UK Government announced its intention to introduce legislation in Finance Bill 2014 to require the National Audit Office to report direct to the Scottish Parliament annually on HMRC's administration of the Scottish rate of income tax. This will ensure that the auditing and reporting arrangements set out in the Command Paper 'Strengthening Scotland's Future', published alongside the Scotland Bill in November 2010, can be fully implemented. Consultation on the draft legislation will take place during autumn 2013.

CHAPTER 3

SCOTTISH TAX ON LAND TRANSACTIONS

The Scotland Act 2012 provides for Stamp Duty Land Tax to be devolved. From April 2015, the UK tax will cease to apply in Scotland and the Scottish Government will be able to levy its own tax in respect of land transactions. The UK tax will be 'switched off' and a corresponding adjustment will be made to the Scottish block grant.

Steps taken towards implementation

18. An HMRC project has been set up to manage the disapplication of Stamp Duty Land Tax for Scotland, with oversight provided by the implementation programme board. The project board includes representatives from HMRC and the Scottish Government. Board members are involved in decision making to ensure that the project provides effective solutions and value for money.

19. The Stamp Duty Land Tax project has focused attention on analysis of how existing HMRC systems will be affected by the disapplication of the tax in Scotland from 2015 and the identification of stakeholders that will be affected by the change. HMRC has so far invoiced the Scottish Government for £18,153 in respect of this work.

20. The design and implementation of the tax set up to replace Stamp Duty Land Tax is a matter for the Scottish Government and Parliament, as this area will be fully devolved. The Scottish Government's consultation on the replacement for Stamp Duty Land Tax took place between June and August 2012. The Land and Buildings Transaction Tax (Scotland) Bill was placed before the Scottish Parliament in November 2012. In June 2012, the Scottish Government announced a new tax authority to administer Scotland's devolved taxes; Revenue Scotland will be set up as an administrative unit of the Scottish Government. More information on the Scottish Government's plans can be found in the Scottish Government's own report on the implementation

of Part 3 which is presented to Parliament alongside this report.

Further steps that will be taken towards implementation

21. In 2013-14, detailed plans will be drawn up for technical changes to existing systems as well as the building and testing of any new components or changes needed to disapply Stamp Duty Land Tax in Scotland. In 2013, further work will be done to produce estimated costs for this work, including estimates from suppliers. An implementation plan will be developed by summer 2014 for review by the Scottish Government before implementation in 2015.

22. The devolution of this tax will be accompanied by a corresponding adjustment to the block grant. Further information on the effects of the tax powers on the Scottish block grant can be found in chapter 7 of this report.

CHAPTER 4

SCOTTISH TAX ON DISPOSALS TO LANDFILL

The Scotland Act 2012 provides for Landfill Tax to be devolved. From April 2015, the UK tax will cease to apply in Scotland and the Scottish Government will be able to levy its own tax in respect of disposals to landfill. The UK tax will be 'switched off' and a corresponding adjustment will be made to the Scottish block grant.

Steps taken towards implementation

23. An HMRC project has been set up to manage the disapplication of Landfill Tax for Scotland, with oversight provided by the implementation programme board. The project board includes representatives from HMRC and the Scottish Government. Board members are involved in decision making to ensure that the project provides effective solutions and value for money.

24. The project team has identified stakeholders and started work to identify potential Landfill Tax customers likely to be affected by the disapplication of the tax in Scotland. It has been established that technical changes to HMRC systems for Landfill Tax are unlikely to be necessary.

25. The Scottish Government's consultation on a Landfill Tax for Scotland took place between October 2012 and January 2013. The Landfill Tax (Scotland) Bill was introduced into to the Scottish Parliament on 17 April 2013.

Further steps that will be taken towards implementation

26. In 2013-14, the focus of the project will be on developing the planning work for the transfer of full responsibility to the Scottish Parliament for the taxation of disposal of waste to landfill from April 2015 as smoothly as possible. A communications plan to provide information to Landfill Tax operators and users of landfill sites in Scotland will also be developed.

27. The devolution of this tax will be accompanied by a corresponding adjustment to the block grant. Further information on the effects of the tax powers on the Scottish block grant can be found in chapter 7 of this report.

CHAPTER 5

BORROWING POWERS OF SCOTTISH MINISTERS

The provisions in the Scotland Act 2012 enable Scottish Ministers to borrow for three purposes from April 2015:

- *for capital investment, Scottish Ministers can borrow up to 10% of the Scottish Government's capital DEL budget each year within a statutory total borrowing limit of £2.2bn. Loans will usually be for a maximum of ten years but with the option of a longer period in line with the expected life of the asset;*
- *to enable the Scottish Government to deal with deviations between forecast and actual revenues, in addition to operating a cash reserve, Scottish Ministers can borrow up to £200m annually up to a total of £500m. Loans will be for a maximum of 4 years; and*
- *to provide the Scottish Consolidated Fund with an appropriate cash working balance to deal with temporary shortfalls between receipts and expenditure. Note that a similar facility existed under the Scotland Act 1998.*

Steps taken towards implementation

28. HM Treasury and the Scottish Government have agreed the following process to enable borrowing for all three purposes from the National Loans Fund (NLF):
    - the Scottish Government should give reasonable notice of its intention to borrow for capital purposes from the NLF. This will include a forecast of expected borrowing during the upcoming financial year, which will be updated at set points during the year. Actual borrowing does not have to be at the exact levels forecast;
    - NLF loans will be administered by HM Treasury with the funds to flow through Scotland Office in line with payment of the block grant. Loans will be available from the NLF following 5 days' notice;
    - Standard NLF terms will apply to each loan – these are the terms available to all approved borrowers and enable loans to be agreed and advanced

quickly. In particular, interest rates will be determined by the Debt Management Office (DMO) and will reflect the rates ruling at the time. The rates, which are published, cover the cost of funding plus a small margin to cover administrative costs.

29. The Scottish Government can additionally borrow from commercial banks for capital investment purposes, while the UK Government has also consulted on enabling the Scottish Government to issue bonds and will respond to the consultation in due course[2].

30. Prior to the full implementation of borrowing powers in April 2015, Scottish Ministers are able to exercise a narrow version of these powers for specified capital expenditure with the agreement of HM Treasury. From 2011-12, Scottish Ministers were able to use prepayments to fund early work on the Forth Road Bridge Replacement Crossing. The full powers will come into effect in April 2015 alongside the introduction of the fully devolved taxes, which will provide the Scottish Government with an independent revenue stream to support borrowing.

Further steps that will be taken towards implementation

31. As noted above, the UK Government will respond to the consultation on Scottish bonds in due course.

[2] The consultation document is available at: http://www.hm-treasury.gov.uk/consult_scotlandact2012_bond_issuance.htm

CHAPTER 6

POWERS TO DEVOLVE FURTHER EXISTING TAXES AND CREATE NEW DEVOLVED TAXES

With the agreement of both governments, further existing taxes can now be devolved and the Scottish Parliament is able to introduce new Scotland-specific taxes. These powers support the ongoing evolution of devolved responsibilities and provide the Scottish Parliament with a new means of achieving policy outcomes, as well as potentially raising additional revenues.

32. A process for creating new taxes and/or devolving existing taxes has been agreed by the UK and Scottish governments. This process involves the following key elements:
    - Initial proposals will be discussed and agreed in principle by both governments prior to moving into a detailed assessment of the evidence base;
    - The assessment phase should be commensurate with the likely impact of the proposal and is expected to include wider consultation on the proposals. It will also explore whether the proposal is consistent with the 'no detriment' principle;
    - If Scottish and UK Ministers are content to proceed following the analysis phase, a legislative process will be taken forward in both the UK and Scottish parliaments prior to the tax being implemented in, or devolved to, Scotland.

33. This power came into force on the same date as the Scotland Act 2012. To date, it has not been used.

CHAPTER 7

EFFECT OF NEW POWERS ON THE SCOTTISH BLOCK GRANT

Since devolution in 1999, the Scottish Parliament has had almost complete flexibility over how it spends its income, the bulk of which has been provided in a block grant determined by the Barnett formula. As set out in the Command Paper published alongside the Scotland Bill, a fundamental principle of tax devolution is that an element of the block grant is exchanged for the ability to levy taxes. In order to ensure that the adjustment process is transparent and equitable, the UK and Scottish governments, through the Joint Exchequer Committee, have agreed a set of overarching principles as the basis for considering mechanisms for adjusting the block grant. Further information on the Joint Exchequer Committee is set out at paragraph 39 of this report and the agreed principles are included at Annex B.

34. As the Scottish rate of income tax represents more than 90% of the value of the tax powers transferred by the Act, it was the initial focus of block grant adjustment discussions between the UK and Scottish governments.

35. Following an assessment of options against the agreed principles, the Joint Exchequer Committee agreed that an adjustment indexed to growth in the UK non-savings, non-dividend income tax base would be most appropriate. This adjustment mechanism provides incentives for the Scottish Government to grow the income tax base in Scotland more quickly than in the UK as a whole, while shielding Scotland from UK-wide economic shocks that the UK Government is better placed to manage.

36. The two governments continue to work together to consider how Scotland's block grant should be adjusted in relation to the smaller fully devolved taxes (Stamp Duty Land Tax and Landfill Tax).

37. Options were discussed by the Joint Exchequer Committee in February, and officials are now engaged in further analysis to assess options against the agreed block grant adjustment principles.

CHAPTER 8

OTHER ACTIVITIES TOWARDS IMPLEMENTATION

38. A range of further activities have also been undertaken over the past year to ensure the smooth implementation of the Act.

Joint Exchequer Committee

39. The UK Secretary of State for Scotland, Chief Secretary to the Treasury and Exchequer Secretary to the Treasury along with the Scottish Cabinet Secretary for Parliamentary Business and Government Strategy and Cabinet Secretary for Finance, Employment and Sustainable Growth formed a Joint Exchequer Committee to discuss and take decisions jointly on the implementation of the Part 3 finance provisions. The Committee first met in September 2011 and has since met twice more, most recently on 14 February 2013. The papers and minutes of the first meeting were exceptionally released and were sent to the Scottish Affairs Committee on 4 September 2012. The minutes are attached at Annex C of this report for information. Notes of subsequent meetings are routinely published by the UK and Scottish Governments in order to provide transparency in this process[3].

Forecasts by the Office for Budget Responsibility

40. The Office for Budget Responsibility (OBR) began to publish forecasts of Scottish taxes in March 2012. Further forecasts were published in December 2012 and, most recently, in March 2013. The OBR will continue to publish these forecasts twice a year, with the next update due in the autumn of 2013[4].

41. This includes a forecast of Aggregates Levy, which has not been devolved as it is currently subject to legal challenge in the European Courts. The UK Government will keep this under review and in the meantime will quantify the share of Aggregates Levy revenues attributable to Scotland.

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[3] Notes of subsequent JEC meetings can be found at:
June 2012: https://www.gov.uk/government/news/joint-exchequer-committee-communique
February 2013: https://www.gov.uk/government/news/joint-exchequer-committee

[4] The OBR's Scottish tax forecasts can be found on its website at:
http://budgetresponsibility.independent.gov.uk/

Cash reserve

42. The cash reserve provides the Scottish Government with a further tool to help manage their new tax powers. In order to support the transition to the new system, Scottish Ministers can currently make discretionary payments into the cash reserve until June 2016 up to an overall total of £125 million. From 2015-16 the Scottish Government will be able to maintain a reserve using an element of tax revenues, which can be accessed if future tax revenues are lower than forecast.

Budgeting arrangements for devolved powers

43. During the next 12 months, one of the key milestones will be agreeing the budgeting arrangements in relation to devolved powers – specifically, how the budgeting framework will support spending funded through devolved tax revenues and borrowing.

44. HM Treasury has been developing proposals during the latter half of 2012-13, which it intends to share with the Scottish Government in the coming weeks. We will report on this to Parliament at the appropriate time.

CHAPTER 9

OTHER REPORTING REQUIREMENTS

45. In addition to the areas covered above (steps taken towards implementation, steps yet to be taken and effect of provisions on the block grant), section 33 of the Scotland Act 2012 requires annual reports on Part 3 of the Act to include:
    - an assessment of the operation of the provisions of Part 3 which have been commenced;
    - an assessment of the operation of any other powers to devolve taxes to the Scottish Parliament or to change the powers of the Scottish Ministers to borrow money, and of any other changes affecting the provisions inserted or amended by this Part;
    - any other matters concerning the sources of revenue for the Scottish Administration (within the meaning of section 126(6) of the 1998 Act) which the maker of the report considers should be brought to the attention of the Parliament of the United Kingdom or the Scottish Parliament.

46. This report is the first following the passage of the Act in May 2012. At this stage, the tax powers have not been devolved and, accordingly, the Government is unable to provide an assessment of the operation of the provisions. It should be noted that, in accordance with section 44(2)(b) of the Act, all provisions of Part 3 came into force two months after the passing of the Act itself, with the exception of section 25(7) (and Schedule 2) - Scottish rate of income tax: consequential amendments - and section 32 - borrowing by Scottish Ministers. The provisions will, however, require Orders from HM Treasury before they can be considered operational. An assessment of the operation of the provisions will therefore follow in further annual reports.

47. At this stage, no other powers to devolve taxes to the Scottish Parliament have been put into operation nor have there been any further provisions to change the powers of the Scottish Ministers to borrow money, and the UK

Government is not aware of any other matters concerning the sources of revenue for the Scottish Administration.

CONCLUSION

48. The implementation of Part 3 of the Scotland Act 2012 is progressing effectively and efficiently. The UK Government is confident that the two governments working together will be able to deliver this historic shift of power from Westminster to Holyrood in the expected timescales.

49. Much has been achieved over the past year, and it is clear that there also remains a substantial amount of work to be done before these provisions become operational. Each Parliament will continue be updated on this work as it progresses.

50. The next annual report on the implementation of Part 3 of the Scotland Act 2012 will be published, in accordance with Section 33(3)(b)of the Scotland Act 2012, before 1 May 2014.

Annex A – Reporting requirements in the Scotland Act 2012 and where they are addressed in this report

1. *a statement of the steps which have been taken, whether by the maker of the report or by others, since the making of the previous report (or, in the case of the first report, since the passing of this Act) towards the commencement of the provisions of this Part,*

   Chapter 2: paragraphs 6-14
   Chapter 3: paragraphs 18-20
   Chapter 4: paragraphs 23-25
   Chapter 5: paragraphs 28-30
   Chapter 6: paragraphs 32-33
   Chapter 8: paragraphs 38-42

2. *a statement of the steps which the maker of the report proposes should be taken, whether by the maker of the report or by others, towards the commencement of the provisions of this Part,*

   Chapter 2: paragraphs 15-17
   Chapter 3: paragraphs 21-22
   Chapter 4: paragraphs 26-27
   Chapter 5: paragraph 31
   Chapter 8: paragraphs 43-44

3. *an assessment of the operation of the provisions of this Part which have been commenced,*

   See chapter 9.

4. *an assessment of the operation of any other powers to devolve taxes to the Scottish Parliament or to change the powers of the Scottish Ministers to borrow money, and of any other changes affecting the provisions inserted or amended by this Part,*

   See chapter 9.

5. *the effect of this Part on the amount of any payments made by the Secretary of State under section 64(2) of the 1998 Act (payments into the Scottish Consolidated Fund),*

   Chapter 7: paragraphs 34-37

6. *any other matters concerning the sources of revenue for the Scottish Administration (within the meaning of section 126(6) of the 1998 Act) which the maker of the report considers should be brought to the attention of the Parliament of the United Kingdom or the Scottish Parliament.*

   See chapter 9.

Annex B - Principles agreed through the Joint Exchequer Committee in September 2011 for the adjustment of the block grant

Design

1. Apply the overarching objective of fairness to both the UK and Scottish Governments by:

    a) minimising the risk of gains/losses from funding transfers on both the UK and Scottish Governments;

    b) ensuring that the mechanism is not, when implemented, designed to gain advantage in one set of fiscal circumstances or another;

    c) considering the effects of a shared tax base (including issues related to policy spillover and tax avoidance).

2. Ensure the mechanism delivers on the Scotland Bill's aims to increase financial accountability, giving the Scottish Parliament a direct financial stake in Scotland's economic success;

3. Ensure the mechanism is consistent with Azores criteria and State Aid principles;

4. Ensure the sustainability of the system to adapt to future decisions on tax devolution;

Implementation

5. Ensure that, when the system is introduced it does not cause an unmanageable change in the Scottish Budget (up or down) in the first year;

Operation

6. Ensure that the necessary information and data is shared on a timely and accurate basis to allow both the UK and Scottish Government to plan ahead;

7. Ensure the mechanism delivers value for money by designing a model that is relatively simple to implement and operate and incurs minimal administrative cost;

Review

8. Apply principles of transparency; and

9. Review to ensure that the system remains fair and 'fit for purpose'.

Annex C – Minutes released following the first meeting of the Joint Exchequer Committee on 27 September 2011

JOINT EXCHEQUER COMMITTEE **JEC/11/01**
27 September 2011

Present:
UK Government
David Gauke, MP, Exchequer Secretary (Chair)
Michael Moore, MP, Secretary of State for Scotland
Danny Alexander, MP, Chief Secretary to the Treasury (part of meeting)

Scottish Government
John Swinney, MSP, Cabinet Secretary for Finance, Employment and Sustainable Growth
Bruce Crawford, MSP, Cabinet Secretary for Parliamentary Business and Government Strategy

In Attendance:
UK Government
David Silk, HM Treasury
Oliver Haydon, HM Treasury
Lucy Proctor, Scotland Office
Alisdair McIntosh, Scotland Office
Paul Doyle, HM Treasury
John Mundy, HM Treasury
Doug Stoneham, Her Majesty's Revenue and Customs

Scottish Government
Alyson Stafford, DG Finance
Gary Gillespie, Chief Economic Adviser
Gerald Byrne, International & Constitution
Gill Glass, Private Secretary
Paul Boylan, Private Secretary

Joint Secretariat:
Jacqui Bishop, HM Treasury
Chris Flatt, Scotland Office
Alistair Brown, Scottish Government
Elspeth Hough, Scottish Government

1. The first meeting of the Joint Exchequer Committee took place in St Andrew's House, Edinburgh, hosted by the Scottish Government. The Chair welcomed participants to this initial meeting, noting that he considered the JEC to be a valuable new forum for discussion of the implementation of the financial provisions which formed key elements of the Scotland Bill. The Chair said that the UK Government had been pleased to accept the proposal that the chairmanship of the Committee should alternate between the two Governments. There were many issues for discussion that would be of importance to both Governments including data sharing and milestones for Scotland Bill implementation.

2. The Cabinet Secretary for Finance, Employment and Sustainable Growth welcomed participants to St Andrew's House and said that the Scottish Government looked forward to fruitful discussions at the JEC. The Scottish Government was committed to working jointly and constructively with the UK Government to find a joint approach acceptable to both Governments.

Key Milestones

3. The Secretary of State for Scotland introduced a paper on Key Milestones for Scotland Bill implementation. The following points were raised in discussion:

- the content of the paper drew on the text of the Command paper, "Strengthening Scotland's Future" which had been published alongside the draft Scotland Bill on 30 November 2010. The paper aimed to set out, briefly, the process for implementation of the provisions contained in the draft Bill and Command paper.

- the paper was a useful starting point; further work was required to be taken forward by officials from both Governments in three areas:
  - First, to develop a shared understanding of the critical path for implementation.
  - Second, it would also be essential to ensure that there would be access to necessary information together with active engagement by Ministers and senior officials from both Governments to provide assurance to the JEC.
  - Third, it would be helpful for the detailed references at table 1 in the paper to commencement of the various provisions to be amended to take account of the commencement arrangements that the Scottish Government had proposed in respect of income tax powers, specifically that formal commencement would be subject to the approval of the Scottish Parliament.

- Both governments were committed to working jointly and constructively and to ensuring that the financial provisions in the Bill were implemented in a way that would be fair and that respected agreed principles.

- There were different views on the approach to commencement. From one perspective, proposals for joint commencement reflected the need for assurance about the effect of technical but potentially very significant financial arrangements in Scotland where a high level of detail would not be available for some time. It was important to focus on the shared ambition to achieve an outcome that was fair, appropriate and non-detrimental and would meet the approval of both Parliaments.

- the Scottish Parliament would need to consider the Legislative Consent Motion (LCM) in early 2012. The information that would then be available on the implementation of the financial provisions was unlikely to provide the level of reassurance the Parliament would require to consent finally to the Bill's proposals. Inclusion of a commencement provision requiring the consent of the Parliament, would enable the Parliament to consent formally to the arrangements agreed between the governments, based on full information, at the appropriate time.

- From the other perspective, the Scotland Bill as it had been developed set out a high degree of certainty; the introduction of commencement orders would introduce uncertainty which would be undesirable and cause delay.

4. <u>The Committee agreed</u> that officials of the Scottish and UK Governments should be asked to develop further the helpful first analysis of key milestones and to update the paper with a view to agreeing this in correspondence. Officials were also asked to look at precedents for commencement orders and to give further consideration to the options.

Terms of Reference
[The Chief Secretary to the Treasury joined the meeting during this item].

5. The Chair introduced the Joint Secretariat's paper on the draft Terms of Reference. This set out the UK Government's proposed Terms of Reference at Annex A**,** which included a number of amendments that had been proposed by the Scottish Government. Further proposed amendments from the Scottish Government were attached at Annex B. Two significant areas of difference remained: the scope and focus of the Committee; and the arrangements for decisions in the event of a failure to reach agreement. The following points were raised in discussion:

- On scope and focus, it was noted that the JEC was the only forum which provided the opportunity for Scottish and UK Ministers to discuss the important and very substantial issues to be addressed in implementing the financial provisions in the Scotland Bill;

- there were other forums to which Ministers could take other issues for consideration;

- the JEC should focus on Scotland Bill implementation;

- the scope of the Committee should not be restricted to the implementation of the Scotland Bill, important as this was;

- it would not be acceptable for decisions to be imposed by the UK Government where no agreement could be reached at the JEC;

- there was a clear shared ambition and an expectation to reach agreement on matters brought to the JEC for decision;

- proposals put forward for a requirement for agreement to be reached were thought to run contrary to the existing devolution settlement. This could be represented as shift in the competence of the two Governments which it would not be appropriate for this Committee to determine;

- tt was important that the Terms of Reference should be drafted with sufficient clarity to endure beyond existing political incumbencies.

6. <u>The Committee agreed</u> that officials from the Scottish and UK Governments should be asked to propose alternative wording on the areas on which no agreement had been reached in this meeting and to ensure that the draft Terms of Reference fully captured the objective of the Committee to reach joint agreement, with a view to subsequent consideration in correspondence.

Block Grant Adjustment

7. The Chief Secretary introduced the UK Government's paper on Block Grant adjustment. This set out high-level principles which would set the framework for development and agreement of a mechanism for block grant adjustment. A suitable mechanism would be consistent with the principles described. The following points were made in discussion:

- This was a useful paper: the principles provided a helpful framework within which to design a mechanism. The inclusion in the principles of a reference to dealing with the effects of policy spillover was welcomed.

- the work to be carried out by the Office of Budget Responsibility would be critical.

- the principles proposed would enable a range of mechanisms to be considered, including the model proposed by Professor Gerald Holtham which was understood to be of interest to the Scottish Government and which the UK Government also considered to have merit.

- the point about access to information was critical. It was essential that the Scottish Government could access, interrogate and understand relevant data held by HMRC.

- there was a shared ambition to keep administration costs low and to ensure that both Governments had access to the right factual information, which might take some time to gather, with a consequent potential impact on the selection of the block grant mechanism.

8. **The Committee agreed the principles outlined in the block grant adjustment paper as the basis for further work on options for mechanisms.**

Communications

9. The Chair noted that it was likely that Ministers from each administration would be required to report to their respective Parliaments on the outcome of the meeting and noted that it was not proposed to publish a joint statement on this occasion.

10. **The Committee agreed** that public statements made by each Government would be in line with the proposed text of the draft Terms of Reference on confidentiality, on which the two Governments were in agreement.

Next meeting

11. The Chair reminded participants that the next meeting of the JEC would be chaired by the Cabinet Secretary for Finance, Employment and Sustainable Growth, in London, in spring 2012.

Joint Secretariat to the JEC

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ISBN 978-0-10-851236-0

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