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Devolution of financial powers to the Scottish Parliament: recent developments

By Antony Seely and Matthew Keep

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Summary

At present there are two sources of revenue under the control of the Scottish Parliament: local taxes (council tax and business rates), in respect of its responsibilities for local government, and the power to impose a 'Scottish Variable Rate' (SVR) of income tax: that is, amending the basic rate of tax by up to 3p in the £.

The *Scotland Act 2012* devolved three further powers: the power to set a Scottish rate of income tax (SRIT) from April 2016, and to introduce taxes on land transactions and on waste disposal from landfill, replacing the existing UK-wide taxes Stamp Duty Land Tax and Landfill Tax from April 2015. The Scottish rate is to apply to income from earnings, profits and pensions, but not to income from savings and dividends. The Act also provides powers for new taxes to be created in Scotland and for additional taxes to be devolved, subject to certain criteria.[1]

During the Scottish referendum campaign, the main party leaders make a commitment that the Scottish Parliament should have "extensive new powers", should Scotland remain within the Union.[2] Following the vote on 18 September 2014 Lord Smith was appointed to lead a commission to reach cross-party agreement on what these new powers should be.[3] . Details of the Commission's work is collated on its own site. The Commission published its report on 27 November 2014.[4]

On tax powers the parties agreed that the Scottish Parliament should have to power to set the rates and thresholds of income tax on non-savings and non-dividend income: devolution of this power will commence on April 2017. There was also agreement that air passenger duty and aggregates levy should be fully devolved. Air passenger duty will be devolved in April 2018; a devolution date for Aggregates Levy is yet to be agreed. All other taxes should remain reserved. Receipts from all income tax paid by Scottish taxpayers on non-savings and non-dividend income would be received by the Scottish Government, as well as receipts from both air passenger duty and aggregates levy. In addition the receipts raised in Scotland by the first 10 percentage points of the standard rate of VAT would be assigned to the Scottish Government's budget. VAT assignment will be implement in 2019/20.

The parties also agreed that "the devolution of further responsibility for taxation and public spending, including elements of the welfare system, should be accompanied by an updated fiscal framework for Scotland, consistent with the overall UK fiscal framework." Scotland's new fiscal framework was agreed in February 2016, following negotiations at the Joint Exchequer Committee, which is made up of representatives of the UK and Scottish Governments.[5]

One aspect of this framework is that the devolution of these tax powers, and (partial) assignment of Scottish VAT revenues, is to be accompanied by appropriate adjustments to,

[1] The changes to be made by the 2012 Act are discussed in, *Devolution of tax powers to the Scottish Parliament: the Scotland Act 2012*, Commons Briefing Paper 05984, 22 January 2015. See also, HM Revenue & Customs, *Scotland Act 2012 guidance*, 19 January 2015

[2] "The vow: three leaders sign promise to Scotland", *Daily Record*, 16 September 2014

[3] 10 Downing Street press notice, *Scottish Independence Referendum: statement by the Prime Minister*, 19 September 2014

[4] For more details see, *Scotland: Devolution proposals*, Commons Briefing Paper 06987, 23 January 2015 & *The Smith Commission: overview*, SPICe Briefing 15/03, 8 January 2015

[5] HM Government & Scottish Government, The agreement between the Scottish Government and the United Kingdom Government on the Scottish Government's fiscal framework

the block grant received from the UK Government - the Scottish Government's largest source of revenue.[6]

In the first year a tax is devolved an adjustment will be made to the block grant equal to the Scottish Government's additional revenue from the tax. Adjustments to the block grant after the first year should then be indexed to reflect the dynamic nature of tax revenues and ensure that neither the UK nor Scottish Government is worse off simply from the devolution of the tax. The block grant will also be adjusted to reflect any newly devolved spending powers.

Replacing some of the block grant – a relatively predictable source of revenue – with less predictable tax revenues will impart volatility to the Scottish public finances. Just how much volatility will depend on how the block grant is adjusted, but the Smith Commission suggested that the Scottish Government would receive further borrowing powers to manage the fiscal risks resulting from tax devolution.

On 22 January 2015 the Coalition Government published draft clauses of how the Commission's Agreement could be implemented.[7] Following the 2015 General Election, the new Conservative Government announced it would introduce legislation to "deliver in full the Smith Commission Agreement" and on 28 May published the *Scotland Bill 2015/16*.[8]

The Bill's provisions in relation to tax do not present any significant changes on the draft clauses published earlier in the year.

This note discusses the Smith Commission's proposals for further devolution of power, in relation to taxation, funding and borrowing, and the Government's plans for their implementation.

6 *The Smith Commission*, 27 November 2014 pp23-7

7 HM Government, *Scotland in the United Kingdom: an enduring settlement*, Cm 8990, January 2015. For more details see, *Draft Scotland Clauses: summary*, Commons Briefing Paper 07090, 28 January 2015.

8 The Bill and its Parliamentary scrutiny to date are collated on its Parliament Bill page. For a detailed brief on the Bill see, *Scotland Bill 2015-16*, Commons Briefing Paper 07205, 4 June 2015.

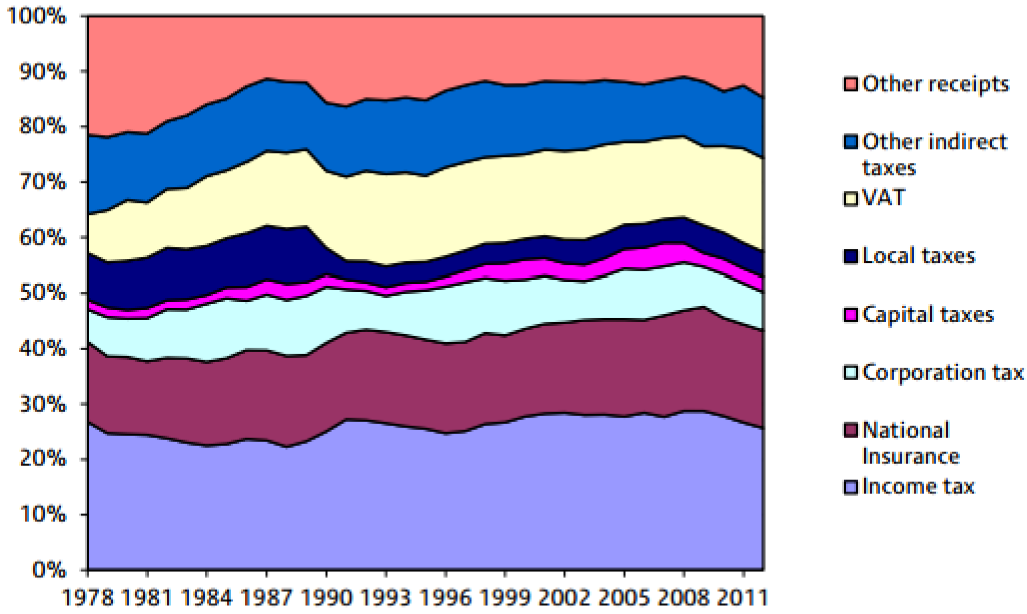
1. The Smith Commission: tax powers

1.1 How much money do taxes raise?

In 2014/15 taxes are forecast to raise £600.5bn.[9] Income tax, National Insurance contributions (NICs) and VAT account for 64% of this total. When one includes corporation tax, just four taxes provide 70% of all the revenue raised by taxes. As the Institute for Fiscal Studies has noted, "the tax system is now very different from the one that existed [in 1979]":

> The income tax rate structure has been transformed, the taxation of savings has been repeatedly adjusted, the National Insurance contributions system has been overhauled, the VAT rate has more than doubled, some excise duty rates have risen sharply while others have fallen, the corporate income tax system has been subject to numerous reforms, and local taxation is unrecognisable. Figure 2 shows the effect that these changes have had on the composition of aggregate government.

Figure 2. The composition of government receipts, 1978–79 to 2012–13



Note: Years are fiscal years, so 2008 means 2008–09.

'National Insurance' excludes NI surcharge when it existed, and 'VAT' is net of refunds paid to other parts of central and local government; these are both included in 'other receipts'. 'Other indirect taxes' are excise duties, environmental taxes and customs duties. 'Corporation tax' includes petroleum revenue tax, the supplementary charge and the 1997–98 windfall tax. 'Capital taxes' are capital gains tax, inheritance tax (and its predecessors) and stamp duties. 'Local taxes' are council tax, the community charge, domestic rates and business rates before 1990; from 1990, business rates are included in 'other receipts'.

Source: HM Treasury.

The shares of revenue provided by different taxes have been remarkably stable since the mid-1990s. The principal change has

9 Office for Budget Responsibility, *Economic & fiscal outlook*, Cm 8966 December 2014 (Table 4.5).

> been in the contribution of corporation tax, which has risen, fallen and then risen again. This largely reflects the changing fortunes of financial companies, whose profits were strong in the late 1990s, weaker thereafter, but then stronger again until the recession that began in 2008/09.
>
> The share of revenue coming from indirect taxes has fallen since the late 1990s, mainly because fuel duties have been cut substantially in real terms. Revenue from capital taxes increased during the period of booming stock and property markets, helped by the introduction of higher rates of stamp duty on property, but still only accounted for 4.25% of total revenue in 2007/08 before falling again in the slump in stock and property markets that began in late 2007.
>
> There have been much bigger changes over the whole period. The most dramatic shifts have been a doubling of the share of revenue flowing from VAT and a substantial reduction in revenue from other indirect taxes. This pattern is mirrored across the developed world, with governments moving away from taxes levied on specific goods towards general consumption taxes such as VAT. The proportion of taxes raised locally has halved, largely because business rates have moved from local to national control. The share of revenue from income tax has remained virtually unchanged, despite radical structural changes. [10]

HM Revenue & Customs provide a disaggregation of tax receipts between England, Wales, Scotland & Northern Ireland. [11] Total tax receipts apportioned on a geographical basis show this split between the four nations as: England (85.9%), Wales (3.4%), Scotland (8.6%), and Northern Ireland (2.5%): [12]

Table 1 Total UK tax receipts (geographical), 1999-00 to 2013-14

	United Kingdom	England	%	Wales	%	Scotland	%	Northern Ireland	%
1999-00	293,803	253,249	86.2%	10,453	3.6%	24,426	8.3%	6,054	2.4%
2000-01	315,537	271,240	86.0%	10,863	3.4%	27,119	8.6%	6,413	2.4%
2001-02	321,062	275,693	85.9%	11,327	3.5%	28,266	8.8%	6,466	2.3%
2002-03	323,710	277,523	85.7%	11,696	3.6%	28,581	8.8%	6,711	2.4%
2003-04	343,632	293,662	85.5%	12,444	3.6%	30,009	8.7%	7,485	2.5%
2004-05	371,045	317,223	85.5%	13,351	3.6%	32,412	8.7%	8,019	2.5%
2005-06	397,929	337,599	84.8%	14,000	3.5%	37,769	9.5%	8,588	2.5%
2006-07	423,674	359,978	85.0%	14,892	3.5%	39,495	9.3%	9,301	2.6%
2007-08	451,053	384,056	85.1%	15,668	3.5%	41,334	9.2%	10,002	2.6%
2008-09	439,095	369,622	84.2%	15,105	3.4%	44,845	10.2%	9,515	2.6%
2009-10	408,497	348,166	85.2%	14,113	3.5%	37,531	9.2%	8,728	2.5%
2010-11	447,153	380,311	85.1%	15,141	3.4%	42,199	9.4%	9,513	2.5%
2011-12	466,624	395,708	84.8%	15,740	3.4%	45,112	9.7%	10,059	2.5%
2012-13	469,763	402,246	85.6%	15,884	3.4%	41,440	8.8%	10,153	2.5%
2013-14	489,850	420,809	85.9%	16,564	3.4%	41,894	8.6%	10,536	2.5%

Note: Percentages may not sum to 100 due to rounding

[10] IFS, *A survey of the UK tax system: Briefing Note BN09*, November 2014 pp40-1
[11] *HMRC statistics: Disaggregation of HMRC tax receipts*, October 2014
[12] HM Revenue & Customs, *A disaggregation of HMRC tax receipts between England, Wales, Scotland & Northern Ireland*, October 2014 p19

Unsurprisingly, HMRC's statistics shows the dominance of the three major taxes.[13] It is important to note that these figures are only for taxes collected by HMRC, so do not include council tax or business rates.

Figures 3 and 4 show how the composition of receipts has changed over the estimation period, both for the UK and England, Wales, Scotland and Northern Ireland.[14] For the UK, the past fifteen years have seen an increase in revenue from NICs (+2.9 percentage points) and VAT (+2.2 percentage points) and a decrease from IT (-0.8 percentage point) and particularly CT (-3.3 percentage points).

Figure 3 Composition of UK revenues, 1999-00 and 2013-14

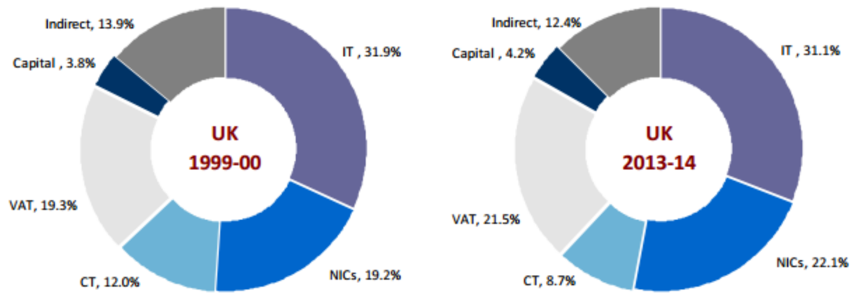


Figure 4 shows that each sub-national area has followed this general pattern though the magnitude has differed from one to the next. Also interesting to note is that the relative shares of VAT and Indirect are higher in Wales and Northern Ireland.

Figure 4 Composition of sub-national apportioned revenues, 1999-00 and 2013-14

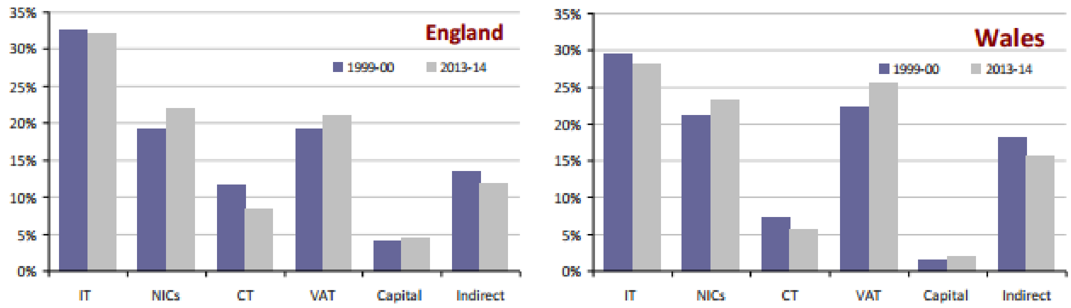
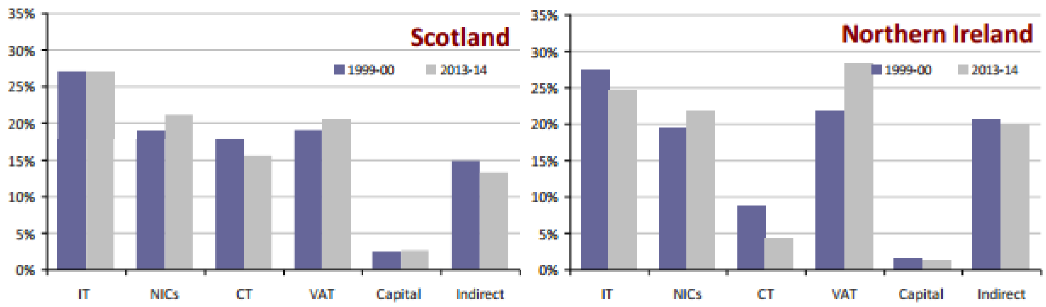


Figure 4 (cont.) Composition of sub-national apportioned revenues, 1999-00 and 2013-14



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13 *op.cit.* pp 10-11

14 Note that the 'CT' category also includes Bank Levy and PRT as well as Corporation Tax; 'Capital' includes Capital Gains Tax, Inheritance Tax, Stamp Duty Land Tax, Stamps on Shares, Annual Tax on Enveloped Dwelling and the Swiss Capital Tax; 'Indirect' includes all excise, transport and environmental taxes, plus Customs Duties; 'IT' includes the Bank Payroll Tax as well as Income Tax.

1.2 What did the Smith Commission propose?

On 27 November Lord Smith presented the Commission's report, and in his speech explained how changes to the Scottish Parliament's financial powers would make it more accountable:

> The Parliament will now be more accountable **and** responsible for the effects of its decisions and their resulting benefits or costs.
>
> The composition of the Parliament's income will change markedly. Significantly more devolved spending in Scotland will now come from tax raised in Scotland with the remainder coming from the block grant provided by the UK Government.
>
> To balance this increased financial responsibility the Parliament will be given increased borrowing powers, to be agreed with the UK Government, to support capital investment and ensure budgetary stability.
>
> The Barnett Formula will continue to be used to determine the remaining block grant. New rules to define how it will be adjusted at the point when powers are transferred, and thereafter, will be agreed by the Scottish and UK Governments. Those rules will be put in place prior to the powers coming into force to ensure that neither the Scottish nor UK Governments will lose or gain financially from the act of transferring a power.
>
> So specifically on taxation:
>
> The Parliament will be given the power to set income tax rates and bands on earned income and will retain all of the income tax raised in Scotland;
>
> The Parliament will be assigned the first 10 percentage points of VAT raised in Scotland;
>
> And Air Passenger Duty and Aggregates Levy will be fully devolved. [15]

The Commission underlined that income would remain "a shared tax" and "would continue to be collected and administered by HMRC":

> **Income Tax**
>
> 75. Income Tax will remain a shared tax and both the UK and Scottish Parliaments will share control of Income Tax. MPs representing constituencies across the whole of the UK will continue to decide the UK's Budget, including Income Tax.
>
> 76. Within this framework, the Scottish Parliament will have the power to set the rates of Income Tax and the thresholds at which these are paid for the non-savings and non-dividend income of Scottish taxpayers (as defined by the Scotland Acts).
>
> 77. As part of this, there will be no restrictions on the thresholds or rates the Scottish Parliament can set. All other aspects of Income Tax will remain reserved to the UK Parliament, including the imposition of the annual charge to Income Tax, the personal allowance, the taxation of savings and dividend income, the ability to introduce and amend tax reliefs and the definition of income.
>
> 78. The Scottish Government will receive all Income Tax paid by Scottish taxpayers on their non-savings and non-dividend income with a corresponding adjustment in the block grant received from

[15] Smith Commission, *Lord Smith of Kelvin's Speech*, 27 November 2014

> the UK Government, in line with the funding principles set out in paragraph 95 [of this Report].
>
> 79. Given that Income Tax will still apply on a UK-wide basis, albeit with different rates and thresholds in Scotland, it will continue to be collected and administered by HMRC. In line with the approach taken for the Scottish rate of Income Tax, the Scottish Government will reimburse the UK Government for additional costs arising as a result of the implementation and administration of the Income Tax powers described above.[16]

Assignment of revenues from each of these taxes would be accompanied by a "corresponding adjustment" to the block grant, in line with certain funding principles (this is discussed in more detail in section 2.1 of this note); these principles included that "no detriment" should result from the decision to devolve a tax power, or from a policy decision made subsequently by either Government:

> **(3) No detriment as a result of the decision to devolve further power**: the Scottish and UK Governments' budgets should be no larger or smaller simply as a result of the initial transfer of tax and/or spending powers, before considering how these are used.
>
> This means that the initial devolution and assignment of tax receipts should be accompanied by a reduction in the block grant equivalent to the revenue forgone by the UK Government, and that future growth in the reduction to the block grant should be indexed appropriately.
>
> Likewise, the initial devolution of further spending powers should be accompanied by an increase in the block grant equivalent to the existing administrative savings arising to the UK Government from no longer delivering the devolved activity, and a share of the associated implementation and running costs in the policy area being devolved, sufficient to support the functions being transferred, at the point of transfer.
>
> The future growth in the addition to the block grant should be indexed appropriately.
>
> **(4) No detriment as a result of UK Government or Scottish Government policy decisions post-devolution**
>
> Where either the UK or the Scottish Governments makes policy decisions that affect the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving. There should be a shared understanding of the evidence to support any adjustments.
>
> Changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK. Changes to devolved taxes in Scotland should only affect public spending in Scotland.[17]

Finally it is worth noting that with regard to both air passenger duty and aggregates levy, the Commission anticipated that the Scottish Government would "be free to make its own arrangements with regard to the design and collection of any replacement tax."[18]

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16 Smith Commission. *Report of the Smith Commission for further devolution of powers to the Scottish Parliament*, November 2014 p23
17 *Report of the Smith Commission*, November 2014 para 95(3)-(4)
18 *Report of the Smith Commission*, November 2014 para 86,89

In a paper on the Commission's report David Phillips at the Institute for Fiscal Studies, concluded, "taken together, the changes proposed would significantly increase the proportion of Scotland's budget that is funded by tax revenues under its control or assigned to it by the UK government." [19]

Focusing on income tax, "based on 2012/13 receipts, Scotland would keep around £10 billon of income tax revenues (compared to around £4.3 billion under the 2012 Scotland Act, and nothing currently.)" [20] The paper goes on to give a breakdown of the tax revenues that the Commission had flagged for devolution:

> At present around 13% of Scottish Government and Scottish local government expenditure is funded by devolved taxes – business rates and council tax. This is set to increase to around a quarter under the plans for partial devolution of income tax, and the full devolution of stamp duty land tax and landfill tax under the 2012 Scotland Act.
>
> Table 1 [overleaf] shows that under the Smith Commission's proposals somewhat over *half* of Scottish Government spending (including the newly devolved benefits spending) will be funded by devolved tax revenues.
>
> This brings Scotland and the UK closer to the position in most other OECD countries, where sub-national governments (such as the Scottish Government, in this context), are responsible for raising a substantial proportion of what they spend[21] …
>
> More than half the taxes paid in Scotland will still flow to Westminster: much of this will, in effect, flow back to Scotland in its remaining block grant from the Treasury, with the rest helping to pay for areas of spending that remain the responsibility of the UK government

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19 David Phillips, *The Smith Commission's Proposals – how big a change do they represent? And what questions remain to be addressed?,* Institute for Fiscal Studies Briefing Note BN157, December 2014 p2

20 *op.cit.* p4. This compares to total income tax revenues in that year of £10.9 billion according to *Government Expenditure and Revenues Scotland 2012–13*. Revenues under Smith Commission proposals are assumed to be 93% of the total, based on figures cited by the Calman Commission. Figures for revenues under the Scotland Act are taken from the OBR's forecasts for Scottish revenues.

21 Data is available from the OECD.

Table 1 Taxes to be devolved under Smith Commission proposals, and their 2012–13 revenues

Tax	Revenues (£s billions)	Devolution proposed
Income tax	10.9	Over 90% of revenues devolved
National Insurance	8.5	No
VAT	8.3	Approx. half revenues assigned
North Sea taxes	5.6	No
Onshore corporation tax	2.9	No
Council tax[a]	2.4	Already devolved
Fuel duties	2.3	No
Non-domestic rates[a]	2.2	Already devolved
Alcohol and tobacco duties	1.6	No
Stamp duty land tax	0.3	Devolved under Scotland Act 2012
Air passenger duty	0.2	Yes
Stamp duty on shares	0.2	No
Landfill tax	0.1	Devolved under Scotland Act 2012
Aggregates levy	<0.1	Yes, subject to state aid rules
Other taxes	1.7	No
Memo		
Scottish Govt spending (inc proposed devolved benefits)[b]	36.8	n/a
Approximate tax revenues to be devolved[b,c]	19.4	n/a

Note: (a) These figures are adjusted to account for reliefs and subsidies – such as council tax benefit, which are netted off reported figures. (b) Excludes spending on public service pensions by the Scottish Pensions Agency, which is part of annually managed spending, and not funded via the Scottish block grant. Includes council tax revenues which are collected and set by local authorities, but ultimately under the control of the Scottish Government. (c) It is assumed that 93% of Income tax is devolved to Scotland, and £4.0 billion of VAT is devolved.

Source: Government Expenditure and Revenue Scotland 2012-13, HMRC disaggregated tax receipts (for VAT), and Scottish Draft Budget 2015–16.[22]

As part of its inquiry into the Smith Commission, on 14 January the Scottish Affairs Committee took evidence from David Phillips from the IFS, and from Professor John McLaren from the University of Glasgow. One issue discussed was the particular selection of tax powers that the Commission had highlighted for devolution. Mr Phillips argued that there were good reasons for *not* devolving the other major taxes: corporation tax, National Insurance, and VAT:

> Why might you not want to devolve corporation tax? It is one where there is particular scope for avoidance and profit shifting, and there are real complexities in cross-border issues which can cause hassle for businesses. I think they made the right decision not to devolve that, at least unless there is a more fundamental rethink

[22] *The Smith Commission's Proposals,* December 2014 pp11-12

> about how corporation tax should be done across the whole of the UK ...
>
> National insurance was not devolved. Here, the reasoning was that there is a strong link to the welfare system, to pensions in particular. I do not have a huge amount of sympathy for that view. The links nowadays between national insurance contributions and benefit entitlements are really weak. In effect, national insurance is just another tax on earned income, so by not devolving that but devolving income tax, you now effectively have one tax on income that is devolved and one that is not devolved...
>
> VAT could not have been devolved because of EU rules on things here. I guess there are similar rules on duties, so there are clear reasons there.[23]

He also noted that one reason for not devolving taxes on Scottish gas and oil revenues was less to do with the nature of the tax, but the difficulties this would create for the block grant:

> One reason you might think it is a good tax to devolve is that the kinds of tax you might want to devolve are those where the tax base is relatively less mobile, because by devolving it there is less chance of tax competition. For instance, if you look at corporation tax you have the North Sea element and the onshore element. Onshore corporation tax can be shifted all over the place because of transfer pricing and profit shifting, but North sea production takes place in the North sea and is less easy to move.
>
> On the one hand, that would make it a relatively attractive tax. It is fixed in Scottish waters. But— …. We have just been talking about how volatile those tax revenues are. They go up and down from year to year. That has two implications. First, if Scotland is bearing the risk of those revenues it would need substantial borrowing powers …
>
> Secondly, it also causes problems for how you adjust the block grant. If revenues are going up and down every year, how much do you adjust the block grant each year? One of the ways it has been done under the Scotland Act, which is attractive—it is in the proposals of the Smith Commission as well—is to index it to what happens to the tax revenues in the rest of the UK, but for the North sea there just aren't those tax revenues, and the small amount there is might be changing in very different ways given what is happening in the North sea. If they discover one new field in English waters, that could lead to a sudden big increase in revenues in England that is not happening in Scotland. How do you adjust the block grant in that situation?[24]

In discussing the Commission's choices, Professor McLaren raised concerns that the report did not provide any details as to *why* a particular power had been tipped for devolution, as opposed to any other:

> ***Professor McLaren***: One of the problems with the package is that you accept the whole thing; you do not go through it one by one and say, "That's why we did this." I read Lord Smith's evidence to you of a few weeks ago. He said that some things were

[23] Scottish Affairs Committee, *Oral Evidence: The Smith Commission - proposals for further devolution to Scotland*, HC 835,14 January 2015 p26, Q339

[24] HC 835,14 January 2015 p18, Qs318-9. Mr Phillips and Mr Johnson also explored this issue when they gave evidence three months before to the Treasury Committee (HC 760, 28 October 2014 pp27-8, Qs93-95). This is discussed in the next section of this note.

> immediately on or off the board. There was no discussion about economic merits or anything like that; it was just, "Well, we know that's not going to happen, but we definitely want that."
>
> I think it makes it more difficult to persuade people in general that it is the best package when you cannot go through it and say, "So you all agreed about North sea oil taxes"—"No, we didn't." Two parties clearly wanted it and the others did not. As part of the package you do not get it. As to corporation tax, two parties clearly wanted it; the rest did not, but it was part of the package. It is a package, but not one that has been agreed point by point, and that perhaps could lead to issues further down the line …
>
> ***David Phillips***: To some extent, an explanation of the rationale behind choosing the taxes is what is lacking in the Smith Commission. I am not sure whether that was purposeful, in the sense that they were presenting it as a political package and deal and therefore they did not want it to be unpicked by providing that detail, but it is in sharp contrast to the Silk Commission, the Calman review and the Holtham Commission, all of which published very detailed analyses of why they came to their conclusions about specific taxes and areas of spending. Maybe that is one of the drawbacks when you do something to such a quick political timetable; you do not actually get to look at all the economics behind it as well.[25]

In press coverage of the Commission's report, many commentators focused on income tax. An editorial in the *Financial Times* argued that the proposals for tax devolution had "managed to stop short of the point at which they might destabilise the UK":

> Several traps were sprung. Rates of corporation tax, VAT and fuel duty remain a matter for London, which sensibly avoids creating scope for harmful tax competition. The commission's deliberations were explicitly divorced from other constitutional wrangles, such as the Conservatives' insistence on English votes for English laws. This should hold back a devolutionary arms race in which extra English demands inspire more from the Scottish.[26]

A leader in the *Times* argued that "Holyrood has won the freedom to set its own rates and bands for income tax [which] … is a result of the logical momentum that has been driving towards a more federal Britain for longer than a decade." It went on to suggest that there were potential risks from income tax remaining 'shared':

> There is a very real risk of chaos. If, as seems likely under the energetic aegis of their new leader, the Scottish nationalists pick up a majority of the Scottish seats in the House of Commons at the next election, they will be the pivotal force in a delicately balanced parliament. Any government relying on their votes to pass changes to income tax in the rest of the UK would face an immediate and trenchant challenge to its legitimacy. The budget could founder.[27]

An editorial in the *Guardian* welcomed the decision not to devolve other taxes, but raised similar concerns that wider constitutional questions remained unsettled:

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25 HC 835,14 January 2015 pp27-8, Q340

26 "Editorial: Westminster cuts the purse strings to Scotland - Scottish nationalists should accept Smith commission proposals", *Financial Times*, 27 November 2014

27 "Leader: The Price of Union", *Times*, 28 November 2014

> Quite rightly, Smith rejects a race to the bottom on corporation tax rates, as well the cross-border shopping bonanza that variable VAT would invite … The eye-catching change concerns income tax … [Smith] suggests that Scotland be freed to do what it likes with all rates and bands. Westminster's reserving of the allowance looks like a unionist fig leaf: Holyrood could effectively raise it, by introducing a starting rate and cutting it to zero. The Smith vision of Scotland was not on the ballot paper this year, and no one has voted for it. But it is as good an interpretation as any other of what Scotland meant by its less-than-overwhelming rejection of independence …
>
> [However] much … remains to be settled after an unpredictable general election. After that, English voices may press the West Lothian question afresh. They will be emboldened by the logic of Smith, which implies – for the first time – that a UK budget could raise income tax rates without automatic consequence in Scotland. Smith has done a good job in imposing a sense of coherence on a fast-evolving constitutional mess. But there won't be a lasting settlement until the mess is tidied up. It is time for a constitutional convention, covering the whole of the UK.[28]

Writing in the *Financial Times* John McDermott discussed the case for further devolution of tax powers:

> Economic theory gives qualified support to "fiscal federalism". So long as the taxes to be devolved are hard to evade, and the local politicians cannot easily renege on their commitments and they carry the responsibility for failure, the devolution of taxes to levels below central government can be both efficient and equitable. In other words, it can work well when the local politicians have the right incentives to expand their economy, increase the tax base and where they are held to account when they fail.[29]

Mr McDermott went on to suggest that the Commission was unlikely to "end discussions about whether Scotland should have more powers in the future – including independence." One reason for this would be disagreements over the best method to debate and agree income tax measures:

> If Scots control all of the decisions about income tax then the inconsistency of having Scottish MPs voting on the rest of the UK's income taxes becomes an obvious grievance for English MPs. They may want Scottish MPs to be prevented from voting on non-Scottish income taxes. And yet what the rest of the UK decides will have a huge influence on the Scottish economy. This could foster resentment in Edinburgh.[30]

The Chartered Institute of Taxation argued that the Commission had made a "pragmatic set of proposals which shows a lot of thought has been given to balancing the desire of Scots for greater tax powers against the practical obstacles to devolution in many areas":

> [In response to the Commission's report] Moira Kelly, Chair of the CIOT's Scottish Technical Committee, commented … "Income tax always looked the most obvious candidate for further devolution.

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28 "Editorial: patchwork power UK", *Guardian*, 27 November 2014

29 [The author cited an earlier article in the paper, "Federalism is a cinch and it will make for a better realm", 24 September 2014, which had discussed the analysis in, Professor David Bell and David Eiser, *Scotland's fiscal future in the UK*, 2014.]

30 "Off Message blog: Scotland: the Basque Country of the UK", *Financial Times*, 26 November 2014

> It is our biggest revenue raiser, generating about a quarter of all tax receipts across the UK. The Scottish Parliament already has some income tax powers, and further changes will come in in April 2016, when the Scottish Parliament gets the power to raise or lower rates by up to 10p in the pound, but only in lock step, moving all three current rates by the same amount.
>
> "These proposals go much further. Not only will the Scottish Parliament be able to vary the three rates independently they will be able to introduce new rates, abolish rates, and move the thresholds where you start paying a different rate. This will give the Scottish Government a lot more options.
>
> "Restricting the devolution to rates and thresholds, while keeping powers over tax reliefs and definitions of income at Westminster, will transfer substantial budgetary powers while maintaining a common tax base across the UK. This will keep additional complexity to a minimum." [31]

From a technical perspective David Phillips at the IFS – in his paper cited above – has argued that the proposals would provide the Scottish Government "with better aligned incomes to change tax rates" compared with the position under the 2012 Act:

> Consider an increase in the rate of tax – which has a direct 'mechanical' effect of increasing revenue, but a second round 'behavioural' effect, which may reduce revenues as people cut back how much they work (or at least how much they declare to the tax authorities!). Under existing legislation due to take effect in April 2016, Scotland would have gained the full revenues arising from the 'mechanical' effect, but borne the 'behavioural' effect only on its 10-pecentage point share of income tax: the remaining behavioural effect (on 10 percentage points of tax for the basic rate, 30 for the higher rate, and 35 for the top rate) would be borne by the UK government. This would skew Scotland's incentives towards tax rises and against tax cuts. [32]
>
> If Scotland keeps all tax income tax revenues this situation does not arise: it bears both the full 'mechanical' and 'behavioural' effects of a change in tax rates on income tax revenues in Scotland. This should better align its incentives to set tax policy accounting for the feedback effect of changes in tax rates on peoples' behaviour. [33]

The author goes on to discuss the possible implications of having rate differentials between Scotland and the rest of the UK, particularly for those on the highest incomes:

[31] CIOT press notice, *'Pragmatic' devolution proposals welcomed by Tax Institute*, 27 November 2014

[32] These problems would have become particularly acute if the lock-step meaning all rates have to be moved up or down together had been removed without devolving more of the revenues to Scotland. This is because people subject to the top rate (45%) of income tax are particularly responsive to tax changes – meaning a big behavioural effect –, and Scotland would bear a particularly small fraction (10/45ths) of the revenue consequences of these behavioural changes. Scotland could therefore find itself better off from increasing the top rate of income tax, even if it resulted in an overall reduction in the amount of income tax raised in Scotland. This situation has been avoided for Scotland as additional revenues have also been devolved to Scotland. But it is exactly the case in Wales, to which 10 percentage points of each tax band will be devolved, alongside the power to vary each rate individually (for instance, to increase only the top rate). Wales will therefore have skewed incentives to increase the top rate of income tax.

[33] *The Smith Commission's Proposals*, December 2014 p5

> There has already been much talk of the so-called WILLIEs (Working in London, Living in Edinburgh), many of whom work in the financial sector, leaving Scotland if it sets a higher top rate of tax than the rest of the UK.[34] But because tax rates on savings and dividend income are not devolved, people might not have to move to avoid a higher top rate of Scottish income tax: some could incorporate and pay themselves in dividends, or existing owner-managers could shift their remuneration from wages to dividends.
>
> Thus, a higher top rate of tax in Scotland may be even less likely to raise much money than in the UK as a whole … it might be easier to move from Scotland to England, or convert income into dividends, than it is to avoid a tax that applies to the whole of the UK, and to dividends too. Of course, if the Scottish rate of tax applied to dividends too, one of these avenues for avoidance would be closed. However, there are practical difficulties in having different tax rates for dividends in different parts of the UK, and other avenues of avoidance might open up if that were the case, which mean there may be no easy solution to this problem.[35]

Mr Phillips was asked about the risk of this type of tax avoidance, when he gave evidence to the Scottish Affairs Committee in January:

> **Sir James Paice:** One of the questions I was going to ask was whether there was room for people at the higher earnings end to adjust their tax affairs, for want of a better expression, given that income tax is devolved but dividend tax is not.
>
> ***David Phillips***: That is a real possibility, particularly for directors of closely held companies—owner managers of small businesses. Rather than being self-employed, there could be an incentive to incorporate and then pay yourself dividends if they are to be taxed at a lower rate. You might pay less in salary and more in dividends. That means there are probably more avenues for behavioural response if Scotland has a higher tax rate than there would be if the tax rate was higher in the UK as a whole. Evidence from HMRC suggests that the 50p tax rate for the UK as a whole did not raise much revenue, because people responded by cutting income, shifting income and so on. The fact that the Scottish rate will not apply to dividend tax makes it even more likely that the behavioural effects will mean that the top rate of tax does not raise much revenue. It certainly gives big scope for avoidance.[36]

The Committee completed its inquiry on 10 March 2015, concluding, in its view, that "the Agreement represents the best of both worlds":

> It presents Scotland with much greater powers over taxation, meaning for the first time the majority of the money the Scottish Government spends will be paid for by its own taxation. This will it make it more fiscally accountable to the people of Scotland for how it spends their taxes. On the spending side significant powers over welfare will be devolved including a potentially important power to increase each and every benefit. At the same time, Scotland will continue to benefit from pooling risk and resources across the

34 "Charting the rise of the new Willies", *New Statesman*, 23 May 2104
35 *The Smith Commission's Proposals,* December 2014 p6
36 HC 835,14 January 2015 p27, Q340. In an opinion piece in the *Financial Times*, John Kay argued that those taxpayers paying the additional rate were more likely to have more options for relocating than others, limiting any potential extra revenue from higher tax rates on the wealthiest: "Scotland's taxes have nowhere to go but up", 3 December 2014.

> wider tax base of the whole of the United Kingdom, which will protect it from any shocks in Scottish revenues or expenditure.[37]

In relation to financial powers, the Committee's principal concern was the operation of the 'no detriment' principle; "if the Smith Agreement is to be an enduring settlement both Governments must work together in good faith and agree a mechanism to administer a policy of no detriment that is proportionate, fair and based on independently verified data."[38] On taxation, the Committee noted the impact that the fall in world oil prices had had on receipts from North Sea oil & gas, illustrating, in its view, the wisdom of *not* devolving this tax:

> The collapse in the oil price is a stark reminder of the risks that face economies which rely on a volatile revenue stream to fund a large proportion of their public spending. The conclusion of the Smith Commission not to devolve such a volatile source of revenue, nor to recommend full fiscal autonomy, but instead to retain the system of shared benefit and pooled risk across the United Kingdom has already proved to be a wise decision, and one that is of obvious and immediate benefit to the people of Scotland.[39]

1.3 The Treasury Committee's inquiry

In 2014-15 the Treasury Committee held a number of evidence sessions on further fiscal and economic devolution in Scotland. One issue the Committee explored with witnesses *before* the Smith Commission had completed its report was the criteria that should be used for assessing which taxes should be devolved. Frank Haskew & Patrick Stevens, from the ICAEW & CIOT respectively, suggested an "increasing level of difficulty" to devolution, to avoid the tax system becoming far more complex:

> **Frank Haskew**: I think there is an increasing level of difficulty in devolving taxes, isn't there? That comes into both the legislative and the practical, and the ability of HMRC to administer it. You start with land taxes so SDLT is an obvious one, business rates, that sort of area—PRT potentially is in that category, probably slightly further down—and then you are moving further and further away from taxes you can physically levy into transaction taxes. Then it becomes slowly harder and I think you could almost have—we have been working up a little scorecard if you like, but there is an increasing order in which devolution of taxes gets harder.
>
> **Patrick Stevens:** I agree entirely with that. You can easily work down the list of things and powers within, for example, income tax, because whether it is just rates and thresholds and so on or whether it is the amount to be taxed, each time it gets more complicated. The administration increases and in my view you just watch out for avoidance as you go along. I don't think there is a big avoidance question here. You just try to write it in the right sort of way.[40]

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[37] *The Implementation of the Smith Agreement*, HC 835 of 2014-15, 10 March 2015 para 54
[38] *op.cit.* para 35
[39] *op.cit.* para 52
[40] Treasury Committee, *Oral evidence: Proposals for further Fiscal and Economic Devolution to Scotland*, HC 760, 28 October 2014 pp4-5, Q12

Paul Johnson, director of the IFS, suggested three principles: administrative complexity, as highlighted by Mr Haskew & Mr Stevens, behavioural change and tax volatility.

> The second [principle] is associated with the extent to which behavioural change might result. One reason why we currently devolve taxes on property is that property is fixed. You are not going to get too much movement across the board as you are not going to create too much in the way of either complexity or behavioural change. Business rates and stamp duty and so on—perfectly sensible.
>
> The next level down, you might think consumption and income taxes. There is some risk there if you have big differences between the countries, but you can probably design that and many countries have designed different consumption and income tax regimes across states within a unitary state. You would probably put corporation tax and other capital taxes at the bottom of that list because the capacity to change behaviour or change apparent behaviour is more significant.
>
> The third thing I think is important is to do with the scale and the volatility of the tax that you are talking about ... Scotland is very much smaller than the rest of the UK. The UK as a whole can cope with that volatility a lot easier than Scotland could. You would probably need some staggeringly complex mechanism for creating equalisation for compensation through the block grants. I think that issue about scale and volatility is the third important leg of how you might think about devolution of tax powers.[41]

Mr Johnson picked up the last of these points when asked about the choice to assign tax revenues, rather than devolve tax powers. David Ruffley asked how difficult it would be to determine a 'fair share' of receipts from a given tax. In his answer Mr Johnson referred to a wider issue – mentioned by several witnesses – that it was important to consider tax devolution *alongside* changes to the block grant:

> It would not be in the least bit difficult to say Scotland should get x% of the VAT revenues, and offset the appropriate block grant as a result. That might not be a bad revenue to do it with, because VAT revenues are relatively non-volatile so it would not be quite so sensitive to some of the decisions that you would make about how equalisation would happen in the future. You could probably set that fixed for two or three years and then reassess—but you would still have this choice … about whether you were offering Scotland the relative risk or the absolute risk.
>
> If the Scottish VAT revenues continued to rise relative to the rest of the UK, would they get all of that, would they get some of it, as you were describing earlier, or would they face an absolute risk such that if their absolute level went down and the rest of the UK's went down, their total revenues would go down more than proportionately to the change in the VAT?[42]

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41 HC 760, 28 October 2014 p21, Q73. In a later session Professor Alan Trench made a similar case that potential economic distortions should determine the choice of devolved taxes, and the question of assigning revenues rather than devolving powers (HC 760, 4 November 2014, pp10-11, Qs148-51).

42 HC 760, 28 October 2014 p26, Q88. See also, the evidence given subsequently by Dr Angus Armstrong & Professor Alan Trench (HC 760, 4 November 2014, pp1-2, Q122).

From this perspective assigning North Sea oil revenues could present considerable difficulties, an issue Committee Chair Andrew Tyrie took up with Mr Johnson and his IFS colleague, Mr Phillips:

> **Chair:** Do you not think, though, Mr Johnson, with respect to North Sea oil revenues, that it is a matter for the Scottish Government to decide whether they want to absorb the high level of volatility associated with devolution?
>
> **Paul Johnson**: Sure … The difficulty would arise in the negotiation about what that meant for the block grant, I think …
>
> If you do that with petroleum revenue tax, then almost the only thing that matters is how you negotiate how much the block grant is, unless you get a Scottish Government saying, "We do not care. We are willing to see our block grant fall over time."
>
> **Chair:** But, as you have said, that is basically a political decision and a political discussion that needs to be had anyway.
>
> **Paul Johnson**: Technically, it will be extraordinarily difficult to come to an outcome that will be acceptable on both sides. It will be so difficult because you are dealing with three things. You are dealing with a huge amount of volatility year by year, you are dealing with a tax that is going down over time and you are dealing with not knowing what the impact of actual policy change will be. Getting to a clear agreement about how each of those would change the block grant I just think would be a very difficult thing to achieve. I am sure it is not beyond the wit of man, but it would make sorting out corporation tax look pretty easy.
>
> **David Phillips**: Because North Sea revenues are overwhelmingly from Scottish waters, there is not the natural counterpart. One can look at most taxes and say, "Well, let's change the block grant reduction in line with what is happening to the tax revenues in the rest of the UK," but for North Sea oil, because it is nearly all in Scotland, there is not really a tax base in the rest of the UK to see what is happening. By definition, you almost have to have one of these more complicated ways of doing things because we do not have this nice simple comparator to compare to.[43]

After the publication of the Commission's report, on 20 January the Committee took evidence from the Chancellor and Sir Nicholas Macpherson, Permanent Secretary at the Treasury. On this occasion, David Ruffley asked Mr Osborne, "do you think the devolution of tax rates and bands is going to lead to tax competition?" In his answer the Chancellor referred to the fact that the Scottish Government had just announced changes to the new Scottish Land & Buildings Tax, in the light of reforms he had announced to UK stamp duty land tax in his Autumn Statement:

> **Mr Osborne:** Ultimately, it is a decision primarily for the Scottish Parliament and the Scottish Government whether they wish to pursue that or not. I think it is quite interesting that—if I may make an observation—off the back of the changes to stamp duty that we announced in the autumn statement the Scottish Government said that they would revisit their proposals on stamp duty. You could argue that that is a bit of tax competition in action.[44]

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43 HC 760, 28 October 2014 pp27-8, Qs93-5

44 Treasury Committee, *Oral evidence: Proposals For Further Fiscal and Economic Devolution to Scotland*, HC 760, 20 January 2015 p8, Q248. For more details on this

At a later stage in this session there as a discussion of the likely impact of devolving air passenger duty to the Scottish Government. Mike Kane asked the Chancellor about the implications for the rest of the country, if the Scottish Government significantly cut, or scrapped, the duty:

> ***Mr Osborne***: … My personal view is that tax competition is something that we should allow. That is one of the principles of devolution. You and I represent either end of the second runway at Manchester airport—I think our constituency boundary is somewhere in the middle of the runway—and we are well aware of the concern in Manchester, particularly the concern in the north-east of England, around the potential impact of giving Scotland control over air passenger duty.
>
> I think the best approach to dealing with this concern, which I think is perfectly legitimate, is to cross the political boundaries of our two parties to try to find a solution that helps these regional airports that can be affected by an air passenger duty decision north of the border.
>
> HMRC has done some work on this and I think it anticipated that Manchester airport would lose around 3% of its traffic and Newcastle could lose around 10% of its traffic. That was work carried out a couple of years ago, but in Newcastle's case, its traffic was up 12% last year, so I think these are manageable.[45]

Mr Kane went on to ask the Permanent Secretary, "in terms of having such a different tax regime right next door, would we have to think about re-gearing APD? A revenue-neutral way forward would be holidays or turning it into a congestion tax":

> **Sir Nicholas Macpherson**: We keep all taxes under review. Personally, I think a bit of tax competition is quite healthy; obviously, it depends precisely on the area. Just as we have seen with the reforms on stamp duty, I think we will see a degree of iteration. If Scotland were to cut APD hugely, they will bear quite a big cost in the short run and will have to make good that cost, either through higher taxes elsewhere or through lower spending. I see this potentially as a bit of a laboratory where can we learn more about the effectiveness of tax and spending.[46]

On this occasion Members also asked the Chancellor about the possible implications of further tax devolution, for Budget procedure and for the block grant. As noted above, the Commission Agreement states that "MPs representing constituencies across the whole of the UK will continue to decide the UK's Budget, including Income Tax."[47] Stewart Hosie asked Mr Osborne if he agreed that "MPs representing Scottish constituencies should continue to decide income tax rates and bands, which apply to the rest of the UK, once they have been devolved?"

> **Mr Osborne:** … There are clearly going to be elements of the income tax system that remain UK-wide, particularly the definition of "income" and many of the reliefs that attract income tax around savings or business losses or whatever. Clearly, it would not be right to exclude Scottish members from votes on those aspects of income

see, *Stamp duty land tax on residential property*, Library standard note SN7050, 22 January 2015.

[45] HC 760, 20 January 2015 Q271, p14

[46] *op.cit.* p15, Q273

[47] *Report of the Smith Commission*, November 2014 para 75

> tax, and that is how I interpret Smith's words … I believe that as a result of this further devolution we need to have a settlement that is fair to the rest of the United Kingdom as well and that, as part of that, Members of Parliament from England and Wales should be able to vote exclusively on matters that affect England and Wales ... How English votes for English laws or English and Welsh votes for English and Welsh laws apply to the Budget is something you will have to wait a little bit longer to hear my views on.[48]

The Chair, Andrew Tyrie, asked about the 'no detriment' principle would inform changes to the block grant, consequent on policy decisions. Mr Osborne suggested that the detail would be something to be negotiated in the future, though there was some precedent of this principle working in practice:

> In this Parliament we have introduced a Scottish rate of income tax and there, for example in the fiscal agreement we have reached with the Scottish Government, the behavioural effects are taken into account but the second round effects are not. That is the kind of negotiation we are going to need to have. I think the basic principles are clear. They are, first, that there should be no fiscal gain or fiscal loss to either Scotland or the rest of the UK on further devolution and, secondly, that basically—if I can put it like this—you have to live then with the consequences of your decisions once that devolution has taken place.
>
> **Chair:** … Perhaps I could ask a question on substance. Suppose the Scottish Government decide on a substantial rise on the top rate of income tax, with positive effects on the rest of the UK if high-income taxpayers move from Scotland down to the rest of the UK and pay their tax there. If that were to occur, would you interpret the "no detriment" principle to mean that the rest of the UK should compensate the Scottish Government for its decrease in tax yield?
>
> **Mr Osborne**: I should speak here in a personal capacity because, as I say, the UK Government will negotiate this in detail after the general election. My interpretation of "no detriment" is that, in the example you give, Scotland would live with the consequences of having imposed a punitive rate of income tax. If it imposed a punitive rate of income tax and, as a result, people moved from Scotland—partly to the rest of the UK and no doubt partly to other parts of the world—part of the concept of further devolution is that Scotland would live with the consequences of that action; would take responsibility for that action.[49]

At a later stage in the session John Thurso put it to the Chancellor that "the clear intention" of the 'no detriment' principle was "that respective Governments of the two nations or of the different parts of the United Kingdom bear the consequences of their decisions for which they are responsible and that their electorates can call them to account for that?"

> For example, the rate of VAT that was prayed in aid is not devolved and, therefore, does not even begin to fall within this. Is it not a question that electorates can hold to account the people who are making the decisions for which they have responsibility? That is the one overriding core principle and all the rest is flim-flam.

48 *Oral evidence*, HC 760, 20 January 2015 pp4-5, Qs238-9
49 *Oral evidence*, HC 760, 20 January 2015 p2, Qs230-1

> **Mr Osborne**: Yes, I think that is the principle of devolution. It is a positive thing that the Scottish Parliament is going to be more responsible for raising the revenue that it then spends. I think that will change the nature of the Scottish political debate in a positive way and, of course, the people of Scotland can hold their Scottish parliamentary representatives to account for those decisions, just as they can hold their Members of Parliament to account for the decisions that are taken on a UK-wide basis.
>
> The case with VAT I think is a very clever arrangement. This is not devolving the rate of VAT, but, if Scotland took a set of planning decisions or housing decisions or transport decisions that led to more commercial and retail activity in Scotland and VAT went up relative to the rest of the UK, then Scotland would get the benefit of that because of the assignment of the revenues.[50]

1.4 The case of corporation tax

One other aspect of the Smith Commission's report noted by many commentators was the fact that it had *not* recommended the devolution of corporation tax.

For its part the Chartered Institute of Taxation argued that this was "not unexpected":

> If corporation tax were devolved, a complex system similar to that operating in respect of taxation across international borders would need to be developed in the UK to ensure that tax ends up in the right place. As the main UK parties acknowledged in their submissions, the cost and bureaucracy of collecting the tax would have been likely to be disproportionate to the amount raised, as well as potentially generating a cross-border tax race within the UK.[51]

As the Institute for Fiscal Studies noted, this was a notable omission, "especially given that the UK government has agreed, in principle to devolve corporation tax to Northern Ireland":

> Northern Ireland has previously argued that it has special circumstances – an economy with a particularly weak private sector, and a land border with the Republic of Ireland, where corporation tax is just 12.5%, with whom it must for compete for investment. Whether these arguments are valid or not, it seems likely the Scottish Government (and, in all probability the Welsh Government) will argue that similar powers be devolved to Scotland (and Wales) too. This could mean a re-opening of the issue of *what* to devolve, that the Smith Commission has supposedly already addressed.[52]

The possible impact of devolving corporation tax to Northern Ireland was raised in the evidence sessions held by the Treasury Committee, discussed in the previous section. When Paul Johnson & David Phillips from the IFS gave evidence, Alok Sharma asked whether devolution to Northern Ireland would make it "impossible to refuse" for Scotland?"

> **David Phillips:** Ultimately that is a political question … Northern Ireland says it has special circumstances with the border with the Republic of Ireland and the need to compete with the lower tax

[50] *op.cit.* p24, Q302
[51] CIOT press notice, *'Pragmatic' devolution proposals welcomed by Tax Institute*, 27 November 2014
[52] *The Smith Commission's Proposals*, December 2014 pp6-7

> rate there. I know that the Scottish Government says that it wants corporation tax anyway and I am sure that if Northern Ireland gets it, it will definitely want it.[53]

Mr Johnson noted that devolution of corporation tax "would clearly add a layer of complexity" and that there were "ways it might happen that would make it very unattractive for the Northern Irish to make use of it." Mr Sharma asked Mr Johnson to elaborate:

> **Paul Johnson:** There are ways you could do it that would make it unattractive, depending on how much additional revenue they could keep.
>
> **David Phillips:** For instance, when Northern Ireland cuts its rate, you would need to reduce the amount of money that Northern Ireland gets. There are ways you can do that. One is it just bears the cost in Northern Ireland of the reduction of the tax rate. I am aware the Treasury has also been considering whether Northern Ireland should also bear the profit shifting that is taking place from the rest of the UK, so it bears some of the cost on the rest of the United Kingdom.[54]

Mr Sharma went on to ask about the likely size of the behavioural response, and how long it might take in practice to devolve the tax:

> **Q80 Alok Sharma:** Let us say that either Northern Ireland or Scotland get the opportunity to basically set their own corporation tax rate and they make them materially lower than that in the rest of the UK. In your view, is this going to encourage lots of corporates to headquarter there? …
>
> **Paul Johnson:** Putting a number on that is almost impossible because we simply do not have the experience on which to base it. We do not know that that clearly is a result of the southern Irish tax system. Some multinationals, some corporates, have headquartered there. How that would relate to what would happen in Northern Ireland or Scotland, for example, it is just not possible to say, but it is clear that that could happen.
>
> **Q81 Alok Sharma:** If there was to be a change in terms of devolving corporation tax, how long do you think that process would take in terms of the transfer and setting up the systems and all the rest of it? …
>
> **David Phillips:** The process for devolving taxes under the Scotland Act and the Wales Bill envisaged several years. I would imagine that the challenges for corporation tax would be at least as hard as for income tax, and I would say that they would want to give real consideration to the way to do it. Rather than going for the default option of transfer pricing, spend the time to think about how we can do this in a way that still gives incentives for the devolved countries to improve their economy but does not give huge opportunities for tax competition and avoidance across countries. I think it would take some time and it should take some time so it is done right.[55]

In a later session the Committee took evidence from Dr Angus Armstrong (Director of Macroeconomic Research, National Institute of Economic and Social Research), and Professor Alan Trench. Stewart Hosie suggested to

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53 Treasury Committee, *Oral evidence: Proposals for further Fiscal and Economic Devolution to Scotland*, HC 760, 28 October 2014 pp22-23, Q76

54 *op.cit.* p26

55 *op.cit.* p24

Professor Trench that if corporation tax were devolved to Northern Ireland, "the arguments presumably against devolving it to Scotland would disappear like snow off a dyke":

> **Professor Trench:** I would not say they would disappear but they would be a great deal weaker. Certainly if it were devolved outright to Northern Ireland that might in fact not be the case even if there was some form of devolution.
>
> I think one important thing and one difficulty with corporation tax devolution is that to do it in a way that does not create an incentive to brass plating and to shifting corporate transactions, you have to do the sort of approach that is used in Canada and the United States. You provide for different rates of corporation tax to be levied on the profits of companies in different parts of the state according to the proportion of their activity that is there, based usually on payroll. Of course, that then affects the scale of what can be done with it and just how useful a lever it might be.[56]

David Ruffley asked Dr Armstrong "isn't there a strong argument that if Northern Ireland gets devolution of corporation tax Scotland will want it too and why is Northern Ireland wanting it if there is this problem of [corporate tax revenues being especially volatile]?"

> **Dr Armstrong:** There is a problem of volatility but there is a problem of whether by being a lower tax region you can attract more resources into your area and, of course, because just over the border in Southern Ireland they have exactly the sort of border effect. So I can understand why Northern Ireland want it but you are quite right it has all the implications for the rest of the UK, and not surprisingly I would imagine that Scotland would be looking at this very carefully.
>
> In the context of Scotland I do wonder whether there are not other ways of encouraging better corporate behaviour, such as the employers' side of National Insurance, which is basically a payroll tax that actually has a higher yield, is more stable, and might be a better way of thinking about this. But I accept that if Northern Ireland gets it, the negative consequences of Scotland make it more powerful. I am not sure whether that alone means that Scotland therefore should be allowed it because making the system even more complex and having more differential rates would make it worse—
>
> **Mr Ruffley:** And potentially greater inefficiencies.
>
> **Dr Armstrong:** Correct. So I think that this will be unwise. First of all, whether Northern Ireland does it and whether Scotland were to follow suit then I think that would become problematic to an even greater extent.[57]

Mr Ruffely went on to ask "in principle, would there not be a tax competition that the United Kingdom would be letting itself in for if it made corporation tax a devolved tax?"

> **Dr Armstrong:** The short answer to that is, yes, and the tax competition is the inefficiency. That is where businesses allocate their plants in accordance with the lowest tax regime rather than where it is economically most efficient. Of course, if you did devolve

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56 Treasury Committee, *Oral evidence: Proposals For Further Fiscal and Economic Devolution to Scotland*, HC 760, 4 November 2014 p17, Q169

57 *op.cit.* pp18-19, Q172

> the corporation tax then you would also be reducing the block grant. It depends in part on how you would reduce the block grant, so there is a way of at least attempting to mitigate some of this but this becomes awfully messy and you add one efficiency on top of another.[58]

In his Autumn Statement on 3 December 2014 the Chancellor announced that the Government *would* pursue the devolution of corporation tax-setting powers to Northern Ireland, "provided that the Northern Ireland Executive can show that they are able to manage the financial implications."[59] On 23 December political leaders in Northern Ireland concluded the Stormont House Agreement, and on 7 January the Secretary of State for Northern Ireland, Theresa Villiers, confirmed that as a consequence legislation to provide for the devolution of corporation tax from April 2017 would be brought forward.[60] The *Corporation Tax (Northern Ireland) Bill 2014-15* was presented the day after Ms Villiers' statement. The legislation attracted cross-party support, and received Royal Assent on 26 March 2015.[61]

Following the publication of the Bill, the Financial Secretary, David Gauke, wrote to the Treasury Committee, giving a short summary of its provisions, and underlining the Government's view that "Northern Ireland's particular economic circumstances mean there are strong arguments in favour of corporation tax devolution, which do not apply to other parts of the UK." A longer extract from the Minister's letter is reproduced below:

> You will have seen that the Government introduced and published the Corporation Tax (Northern Ireland) Bill on 8 January …
>
> The Bill defines a set of rules on the treatment of losses, reliefs and allowances between Northern Ireland and the rest of the UK, and which activities are not covered by the Northern Ireland regime.
>
> Anticipating potential questions you may have regarding avoidance, the rules have been designed to deter businesses from seeking to exploit, through profit shifting and related techniques, any rate differential between Northern Ireland and the rest of the UK. We have also designed the regime with a strong regard to minimising additional administrative burdens on companies to ensure they can benefit as fully as possible for any decision to lower the rate in Northern Ireland.
>
> I am aware of the particular interest your Committee has taken in the fiscal elements of devolution, including most recently for Scotland, and that you have considered the issue of Northern Ireland corporation tax in the past. As you will know, the Government's view as set out by the Chancellor at Autumn Statement 2014 is that Northern Ireland's particular economic circumstances mean there are strong arguments in favour of corporation tax devolution, which do not apply to other parts of the UK. The Government has however also made clear that

58 *op.cit.* p19, Q173
59 HC Deb 3 December 2014 c314
60 HC Deb 7 January 2015 cc296-7
61 Full details of the Bill's scrutiny are collated on Parliament's site. The background is examined in *Devolution of corporation tax to Northern Ireland*, Commons Briefing Paper 07078, 12 February 2015.

> devolution of this power can happen provided that the Northern Ireland Executive is able to manage the financial implications.
>
> It will be for the Executive to decide what to do with the rate-setting power and how it will manage the reduction in its budget associated with any reduction in the rate of corporation tax, and the 23 December Stormont House Agreement confirmed the need for the Executive to work to balance the Northern Ireland budget.[62]

1.5 Recent developments

The draft Bill – January 2015

On 22 January the Coalition Government published draft clauses of how the Commission's Agreement could be implemented.[63]

Tax was covered in **Part 2** of the Draft Clauses, clauses 10-15, and **Chapter 3** of the Command Paper.

Clauses 10-12 related to the Smith Commission Agreement's recommendations on **income tax**. The Scottish Parliament would have the power to introduce new rates and bands of income tax above the UK personal allowance. This would apply to the same categories of income as the Scottish Rate of Income Tax, as established by the *Scotland Act 2012*: broadly speaking, income from employment, profits from self-employment, pensions, taxable social security benefits and income from property. Similarly, liability to pay would be based on the statutory test for Scottish taxpayers provided by the 2012 Act.[64]

Capital gains tax (CGT) is to remain reserved. At present liability to pay the basic or higher rates of CGT is based on an individual's marginal income tax rate: someone paying income tax at the higher or additional rate is liable to pay the higher rate of CGT on their gains. Clause 12 would ensure that the rate of CGT paid by Scottish taxpayers will continue to be calculated by reference to the UK income tax rate limits.

Clauses 13-15 related to the Agreement's recommendations regarding the **assignment of VAT revenues** to the Scottish Government, and to the devolution of both **air passenger duty** and **aggregates levy**.

Under **clause 13** a share of the receipts from VAT attributable to Scotland would be assigned to the Scottish Government's budget: this would be equivalent to the first 10 percentage points of the revenue from the standard rate of VAT (currently 20%), *and* the first 2.5 percentage points of the revenue from the reduced rate (currently 5%). In his statement to the House, the Minister, David Mundell, noted that the Commission had recommended the first of these measures, "and the Government feel that it is entirely consistent to apply the same recommendation to the lower rate—the 5% rate—of VAT. That will ensure that Scotland receives 50% of the revenue raised."[65] The amounts of VAT attributable to Scotland

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62 Treasury Committee, *Letter from David Gauke to Andrew Tyrie*, 12 January 2015
63 HM Government, *Scotland in the United Kingdom: an enduring settlement*, Cm 8990, January 2015
64 For details see, HMRC, *Scottish rate of Income Tax - technical guidance on Scottish taxpayer status*, 11 June 2015
65 HC Deb 22 January 2015 c383

would be the subject of an agreement between the Treasury and the Scottish Government.

Clause 14 would allow the Scottish Government to charge a tax on air passengers departing from Scottish airports. Similarly **clause 15** would allow the Scottish Government to charge a tax on the commercial exploitation of aggregate. In both cases the draft clauses would allow HM Treasury to 'switch off' these UK taxes in Scotland from a date to be set by secondary legislation.

The Scotland Bill 2015/16

Following the 2015 General Election, the new Conservative Government announced it would introduce legislation to "deliver in full the Smith Commission Agreement" and on 28 May published the *Scotland Bill 2015/16*.[66]

Tax is covered by **Part 2** of the Bill, **clauses 12-14** (income tax), **clause 15** (VAT), and **clauses 16-18** (devolved taxes). These provisions do not present any significant increase, or reduction, in the tax powers to be devolved by the draft clauses published earlier in the year. A number of drafting changes have been made – two of which are worth underlining.

First, **clause 12** provides for the Scottish Parliament to set both the basic rate of tax, and any other rates, as well as the limits for those rates. The Parliament may do this by passing a 'Scottish rate resolution'. All rates must be a whole or half number, *or zero*: **clause 12(5)**. Furthermore, a resolution of this type may *not* provide for different rates of tax to apply to different types of income: **clause 12(3)**.

Second, the Scottish Parliament is to be empowered to introduce its own tax on the carriage of passengers by air from airports in Scotland – **clause 16** – and on the commercial exploitation of aggregate – **clause 17**. In the latter case, the devolved tax *cannot* be charged where aggregate used as a fuel, or is processed in order to extract or produce fuel: **clause 17(2),(3)**.

Notably, in their report on the draft clauses the Scottish Parliament's Devolution (Further Powers) Committee had recommended that the UK Government should clarify "whether the current provisions would permit the Scottish Parliament to set a zero rate of income tax" [67] In other respects the Committee were generally content with the initial drafting of these provisions, although it raised some concerns over how, exactly, Scottish VAT receipts would be calculated:

> There is still significant uncertainty on how the assignment of a share of revenues will be calculated and whether the Scottish Government will be able to reap the rewards of any economic stimulus that yields higher VAT revenues. The Committee recommends that details of the assignment of VAT revenues and

66 Scotland Office press notice, *Scotland Bill published on day one of new parliament*, 28 May 2015. Full details of the Bill and its Parliamentary scrutiny are provided on its Parliament Bill page.

67 *New Powers for Scotland: An Interim Report on the Smith Commission and the UK Government's Proposals*, 14 May 2015, 3rd Report, Session 4 (2015) para 165.

> the share of any benefits be produced before the Scottish Parliament is expected to give its legislative consent. The Committee further recommends that a bilateral process by discussion is entered into between the two governments to reach agreement for the 'verified basis' for VAT attribution to Scotland for assigning the receipts.[68]

In turn the Scottish Government published its response to the Committee's report on 8 June, and on tax, stated that it was "broadly content with the clauses in the Scotland Bill relating to taxation. As the Committee recognised, there will need to be extensive discussions between the Scottish and UK Governments over the plans for implementing these provisions."[69]

The Bill received a Second Reading on 8 June. Introducing the Bill the Secretary of State, David Mundell, summarised its tax provisions as follows:

> Central to the Bill is the devolution of income tax. Although the definition of income tax will remain reserved, the Scottish Parliament will have full control over rates and bands. That builds on the tax devolution set out in the Scotland Act 2012, which provided for significant powers over income tax that will come into effect next April.
>
> One notable change to the Bill, compared with the draft clauses published in January, is the confirmation that the Scottish Parliament will be able to set a zero rate of income tax on earnings if it so chooses. That effectively gives it the opportunity to reduce the individual's tax burden significantly if it can afford to do so and makes appropriate spending cuts or tax rises elsewhere. Of course, the reverse is true—if the Scottish Government want to spend more, they will be able to do so by taxing more, and they will be accountable to the Scottish taxpayer for it.
>
> Alongside the devolution of income tax sits the assignment of half of Scotland's VAT revenues. Members will recall that it is against EU law to have differential VAT rates within a member state, so the devolution of VAT would not be legal … Instead of the devolution of VAT, the Smith commission recommended that half the VAT revenues raised in Scotland should be assigned to the Scottish Parliament, thereby further linking Holyrood's funding to the performance of the Scottish economy. The more the Scottish economy grows, the greater the revenue from VAT that Holyrood will be able to keep. That is an incentive to achieve growth …
>
> The devolution of income tax on earnings and the assignment of VAT revenues, when taken together with the devolution of air passenger duty and the powers under the 2012 Act, mean that the Scottish Parliament will have important decisions to make. The Scottish Parliament is now responsible for raising about only 10% of what it spends, but under the Bill Holyrood will be responsible for raising more than 50% of what it spends. It will truly be one of the most powerful devolved legislatures in the world.[70]

At a later stage in his speech, Mr Mundell underlined the Government's opposition to full fiscal autonomy for Scotland: "my party and the

[68] *op.cit.* paras 506-7
[69] Scottish Government, *Response to the Devolution (Further Powers) Committee*, 8 June 2015 p8
[70] HC Deb 8 June 2015 c926

Government have made it clear that we will strongly oppose full fiscal autonomy for Scotland. As the analysis by the independent and respected Institute for Fiscal Studies told us, full fiscal autonomy would leave Scotland with a £7.6 billion black hole in its finances this year and almost £10 billion by the final year of this Parliament."[71]

Speaking for the Opposition, Ian Murray, suggested a number of changes should be made the Bill to "ensure that Smith is delivered in full, to the letter, in both substance and clauses" – though none of these related to tax. Mr Murray went on to strongly oppose any changes to deliver fiscal autonomy: "we must be vigilant as the Bill makes progress through the House, as the worst case scenario for Scotland would be an SNP asking for its top manifesto priority of full fiscal autonomy and a majority Conservative Government delivering it for them."[72]

Speaking for the SNP, Angus Robertson, argued that the Bill did not reflect the conclusions of the Smith Commission, and went on to suggest the party would table amendments for the devolution of both corporation tax and NICs:

> As we know, the vow was a direct response to the growing momentum of the yes campaign, in which the Better Together parties—Labour and Tory, which had worked closely for two years—descended into breathless panic and promised the earth. More accurately, they promised "home rule" and as close to federalism as possible … There is no doubt whatever that the Bill does not match the pledges of the campaign or the spirit and letter of the Smith deal …
>
> The Bill is a response to the referendum, but we now need an adequate response to the general election and the clear mandate for more powers that was delivered … The manifesto on which I and my colleagues were elected was one that secured the support of more votes in Scotland than the Conservatives, the Labour party and the Liberal Democrats combined. We have been clear on our priorities for more powers, stating that "we will prioritise devolution of powers over employment policy, including the minimum wage, welfare, business taxes, national insurance and equality policy—the powers we need to create jobs, grow revenues and lift people out of poverty."[73]

Concluding the debate the Financial Secretary, David Gauke, gave some details of the ongoing work on the 'fiscal framework':

> I am pleased to say that earlier today the Chancellor and the Chief Secretary to the Treasury met the Deputy First Minister. They had a productive meeting and agreed to immediately start work on the fiscal framework, which works alongside the Scotland Bill, ensuring that the Scottish Parliament has the tools it needs to manage its significant new tax and spending powers. We have agreed to aim to finalise the fiscal framework by the autumn, alongside the passage of the Scotland Bill through Parliament.[74]

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[71] *op.cit.* c931. For more details see, *Full fiscal autonomy delayed? The SNP's plans for further devolution to Scotland*, IFS Observation, 21 April 2015.

[72] *op.cit.* c938

[73] *op.cit.* cc945-6, c951. For some commentary on these proposals see, *Scotland would gain significant new powers under SNP plans for further devolution,* IFS Observation, 22 April 2015.

[74] *op.cit.* c1012

As Mr Robertson said in his speech on second reading, the SNP's election manifesto stated that the party would "seek agreement that the Scottish Parliament should move to full financial responsibility", but that as "the transition to full fiscal responsibility - and agreement of the detailed fiscal framework that would underpin it - would take a number of years", the party would "prioritise devolution of powers over employment policy, including the minimum wage, welfare, business taxes, national insurance and equality policy."[75]

On 15 June the Scottish Government gave more details of the case for devolving 'business taxes', in a document setting out which further powers, in its view, should be devolved. An extract from this is reproduced below:

> **Employers' National Insurance**
>
> A more integrated set of powers over business taxation alongside business rates, corporation tax and capital gains tax could be used to reduce the cost of employment in key sectors. For example, changes could be made to specific elements of the NIC system such as:
>
> - Increase the Lower Earnings Rate. The lower earnings rate is the point at which employers need to start paying NICs[76] … Increasing the rate would reduce contributions for all businesses who are paying NICs, but would have a proportionately greater impact on employers of workers on low wages or/and low hours and may eliminate NICs completely for some employers.
> - Employment Allowance. In 2014, the UK Government introduced an employment allowance which allows companies to reduce their NICs bill by a flat rate of up to £2,000 a year. This allowance could be made more generous or linked to companies paying the living wage.
> - Exempting Certain Groups. From April 2015, employers will no longer have to pay NICs for employees under 21. From 2016, they will no longer need to pay NICs for most modern apprentices under 25. From 2010 to 2013, start-ups outside London, the South East and east of England were exempt from NICs for the first ten recruits they hired during in their first year of trading. Such measures allow reforms to be targeted at specific groups and can therefore be more cost effective than across the board changes to headline rates and thresholds.
>
> **Corporation tax**
>
> Full responsibility for corporation tax, including rates, reliefs, thresholds and the tax base, would allow the Scottish Government to tailor the tax system to reflect the specific competitive strengths and challenges in the Scottish economy …
>
> **Capital Gains Tax**
>
> Full responsibility for capital gains tax could be used to create targeted tax incentives to boost entrepreneurship to redress Scotland's lower rates of entrepreneurship and business start-up.

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[75] *The SNP 2015 General Election manifesto - Stronger for Scotland*, April 2015 p11
[76] Strictly speaking, this is termed the 'secondary threshold' for Class 1 National Insurance contributions.

> For example, we could review the effectiveness of existing entrepreneur's relief (lower tax charge on first £10 million gain arising from sale of business) or seed investment relief (incentivises investment in small, start-up companies).[77]

As noted, clauses 12-18 of the *Scotland Bill 2015* cover taxation, and these were agreed, without amendment and without a division, on the second day of the Bill's Committee stage, on 29 June.[78] On this occasion the Secretary of State, David Mundell, observed, "the clauses on income tax ... are often overlooked, meriting only a few lines in the comments received on the Bill ... because, as has been said, they command widespread support as delivering the central aspect of the Smith agreement in full."[79] On this occasion four new clauses, tabled by Labour and by the SNP, were debated, and voted on – though all four were negatived:

- **New Clause 1 (Labour) -** would have established an independent commission, appointed by the Secretary of State, to analyse the potential impact of the Scottish Parliament having 'full fiscal autonomy'.
- **New Clause 21 (Labour) -** would have established a Scottish Office for Budget Responsibility.
- **New Clause 33 (SNP) -** would have required the UK & Scottish Government to agree a plan to establish 'full fiscal autonomy'.
- **New Clause 54 (SNP) -** would have devolved income tax in its entirety to the Scottish Parliament.

A more detailed summary of these deliberations, and the other days of the Bill's Committee stage, is provided in another Commons Briefing Paper.[80]

In turn the Government tabled a series of amendments to the Bill, designed, in its view, "to improve the effectiveness of the legislation and to ensure that the new powers for the Scottish Parliament work as the Smith Commission intended."[81] These were considered at the Report stage of the Bill on 9 November, along with various new clauses and amendments tabled by both the Labour Party and the SNP.[82] None of the Government's amendments to the Bill related to the tax powers to be devolved, and these remain unamended.

On this occasion the Labour Party moved a new clause, similar to that in Committee, to establish a commission to consider the potential impact of the Scottish Parliament assuming 'full fiscal autonomy', though, as before, this was negatived.[83] The Labour Party also tabled a new clause, to require the Treasury to review the impact of tax devolution on Gift Aid, and amendments to assign to Scottish Government the full amount

[77] *Beyond Smith – Scottish Government proposals for more powers for the Scottish Parliament*, June 2015 para 45-52
[78] HC Deb 29 June 2015 cc1231-1305
[79] *op.cit.* c1247
[80] *Scotland Bill 2015-16: Committee stage report*, CBP7233, 22 October 2015
[81] HC Deb 2 November 2015 cc15-18WS
[82] HC Deb 9 November 2015 cc50-190
[83] *op.cit.* c103. The clause was negative by 341 votes to 191.

of VAT raised in Scotland. In neither case were these put to the vote. The Secretary of State, David Mundell, opposed both changes, for reasons he set out to the House as follows:

> I can confirm that the UK Government remain committed to working with the charity sector to ensure that gift aid works effectively for charities and their donors. This is something that we already do, and something that we will continue to do. We consulted the charity sector fully in advance of agreeing the arrangements for the continued operation of gift aid under the Scottish rate of income tax, which will come into effect in April 2016. Similarly, we are fully committed to consulting the charity sector, in Scotland and the rest of the UK, ahead of agreeing arrangements for the continued operation of gift aid under the devolution of income tax powers as proposed by the Bill ...
>
> I am afraid that I cannot agree with Labour's proposal for the full amount of VAT raised in Scotland to be assigned to Scotland. It was a key part of the Smith agreement that half the VAT revenue should be so assigned, in order to ensure a stable balance between encouraging Scotland's economy to grow and insulating the Scottish Government's budget from UK-wide economic shocks.[84]

[84] *op.cit.* cc99-100

2. The Smith Commission: Scotland's fiscal framework

Scotland's **fiscal framework** is the system within which the Scottish Government funds the services it provides. It includes how the funding is received and the institutional arrangements governing the process.

On 23 February 2016, the UK Government and Scottish Government agreed a new fiscal framework for Scotland. The agreement was published two days later.[85]

The new framework deals with issues arising from the Scotland Bill 2015/16 that impact on the Scottish Government's budget, the control of its public finances and other financial issues that need addressing before devolution is implemented. The fiscal framework addresses issues such as:

- how to adjust the Scottish Government's budget for new tax, welfare and spending powers – often referred to as block grant adjustment
- the borrowing powers the Scottish Government will need to manage tax volatility and economic shocks, and to invest in infrastructure
- the method for assigning VAT revenues
- financial transfers to meet the costs of implementation and administration
- the role of fiscal institutions – such as the Office for Budget Responsibility and Scottish Fiscal Commission – in providing scrutiny of Scotland's public finances

The final issue to be agreed by the two Governments was the block grant adjustment for taxes. It always looked likely that reaching agreement on this would be difficult.

Scotland's new framework will sit within the UK's wider fiscal framework.

2.1 The Smith Commission: the need for a new fiscal framework

The Smith Commission recommended that Scotland needs a new fiscal framework to reflect the devolution of tax and spending powers in the Scotland Bill. The Commission defined the fiscal framework as encompassing:

> […] a number of elements including the funding of the Scottish budget, planning, management and scrutiny of public revenues and spending, the manner in which the block grant is adjusted to accommodate further devolution, the operation of borrowing powers and cash reserve, fiscal rules, and independent fiscal institutions.[86]

85 HM Treasury & Scottish Government, The agreement between the Scottish government and the United Kingdom government on the Scottish government's fiscal framework, 25 February 2016

86 Smith Commission. Report of the Smith Commission for further devolution of powers to the Scottish Parliament, November 2014 para 95

The Smith Commission said that the framework should maintain the Barnett formula as the method for determining changes in Scotland's block grant (see Box 1).

In the main primary legislation is not required to update the fiscal framework. The Smith Commission suggested that the Scottish and UK Governments should jointly work via the Joint Exchequer Committee (JEC) – made up of representatives from each Government – to agree the new fiscal framework.

Box 1: The block grant and Barnett formula

The UK government currently provides funding for the majority of the Scottish Government's budget as a block grant.

Annual changes to the block grant are determined by the Barnett formula[87] which ensures that the Scottish Government's block grant receives a population share of changes in UK government spending on areas that are devolved to the Scottish Parliament.[88]

The Scottish Government has discretion over how to spend the funds allocated to them. For instance there is no requirement that they spend the Barnett consequentials from increased education spending in England on education.

The arrangements for funding Scotland have been in place since the late 1970s and were largely unchanged by the introduction of devolution.

2.2 Block grant adjustment for devolved taxes

How the block grant should be adjusted and this adjustment changed over time, or indexed, was the final part of the fiscal framework to be agreed. Even at the start of negotiations reaching an agreement didn't look straightforward. Despite many options being available, reaching an agreement that is fair and acceptable to both Governments, leaving neither worse off and meeting principles set out by the Smith Commission looked difficult.

The agreement reached in the fiscal framework means that during a transitional period the Treasury's preferred method for indexing the block grant adjustment for taxes will be used, but an adjustment will be made to ensure that the outcome reached is the same as would have been reached under the Scottish Government's preferred method.[89]

The Smith Commission

The Smith Commission recommended that Scotland's block grant should be adjusted where a tax or spending power is devolved. In the case of a devolved tax power the block grant should be reduced to reflect the additional revenue raising powers of the Scottish Government. In the case of a spending or welfare power the block

87 For further discussion see: Barnett formula, Commons Library Research Paper 07/91, 14 December 2014; and, HM Treasury, *Statement of funding policy*, October 2010

88 The three factors that are multiplied to determine the Barnett consequential are: the quantity of the change in planned spending in United Kingdom Government departments; the extent to which the relevant United Kingdom departmental programme is comparable with the services carried out by each devolved administration; and

89 HM Government & Scottish Government, The agreement between the Scottish Government and the United Kingdom Government on the Scottish Government's fiscal framework, February 2016, para 11-19

grant should be increased to reflect the Scottish Government's additional spending commitments.

Making the block grant adjustment for a devolved tax in the first year appears to be fairly straightforward – a reduction equivalent to the amount of revenue being transferred to Scotland is made. But in the years that follow the same adjustment cannot be used: economic growth and inflation typically lead tax revenues to grow over time so the adjustment must be indexed in some way. The Smith Commission did not propose any method for doing this.

Smith Commission: 'no detriment' principles

The Smith Commission proposed two principles of 'no detriment' to underpin the devolution of tax and spending power. There principles provided some parameters within which negotiations on block grant adjustment could took place.

The first no detriment principle said that the initial transfer of power should have no detrimental impact on the Scottish and UK Government's budgets.[90] Put another way, neither Government's budget should be adversely affected simply from the transfer of the tax power.

The second no detriment principle related, in part, to taxpayer fairness. This said that changes in devolved taxes in the rest of the UK should not affect the level of public spending in Scotland after the transfer of tax powers has taken place. In other words, public spending in Scotland should not benefit from an increase in devolved taxes in the rest of the UK, nor should public spending in Scotland lose from a decrease in devolved taxes in the rest of the UK.

Due to the interactions between the Barnett formula and tax revenues, achieving 'taxpayer fairness' was described as difficult in the draft bill's accompanying Command Paper.[91] The Command Paper provided two examples which highlight the issue:

> **i. Decrease in 'rest of UK' income tax** – if the UK Government reduces spending on devolved areas (e.g. health, education, housing, policing, justice etc) to manage a decrease in 'rest of UK' income tax, then the Barnett Formula will lead to a population share of this spending reduction affecting Scotland through a decrease in the Scottish Government's block grant (despite the tax not applying in Scotland). If the UK Government instead reduces spending on reserved areas (such as pensions, benefits, defence, debt interest etc) then this spending reduction would again apply UK-wide, including in Scotland, despite the 'rest of UK' income tax not applying in Scotland. The tax deduction element of the funding model therefore needs to work alongside the Barnett Formula to ensure that decreases in 'rest of UK' tax do not lead to reductions in spending in Scotland.
>
> **ii. Increase in 'rest of UK' income tax –** if the UK Government spends extra 'rest of UK' income tax on devolved areas (e.g. health, education, housing, policing, justice etc) then the Barnett

90 *Report of the Smith Commission*, November 2014 para 96
91 HM Government, Scotland in the United Kingdom: An enduring settlement, para 2.4.13– 2.4.17

Formula will lead to a population share of this extra funding being spent in Scotland through an increase in the Scottish Government's block grant (despite the tax not applying in Scotland). Similarly if the UK Government spends this extra funding on reserved areas (such as pensions, benefits, defence, debt interest etc) then this would be spent UK-wide, including in Scotland, despite the 'rest of UK' income tax not applying in Scotland. The tax deduction element of the funding model therefore needs to work alongside the Barnett Formula to ensure that increases in 'rest of UK' tax do not fund higher spending in Scotland.

Discussion of indexing the block grant adjustment

Since the Smith Commission report was published block grant adjustment has been discussed in many reports from think-tanks and UK and Scottish Parliament Committees (see Box 2). Common points have been that:

- it looks like a tall order, if not impossible, to design a block grant adjustment system for taxes that achieves Smith's 'no detriment' principles while the Barnett formula remains in place
- the different adjustment options could bring significantly different impacts on the Scottish budget
- the chosen block grant adjustment method will impact on how risks are shared between the UK Government and Scottish Government. For instance some methods would expose the Scottish Government's budget to the risk of its population growing slower relative to the UK's

Box 2: Discussion of different ways of adjusting the block grant

The following publications discuss block grant adjustment – this list is not exhaustive:

- House of Lords Economic Affairs Committee, A Fracturing Union? The Implications of Financial Devolution to Scotland, 20 November 2015, HL Paper 55
- House of Commons Scottish Affairs Committee, Revising Scotland's fiscal framework, 8 February 2016, HC660, Chapter 4
- Scottish Parliament Information Centre, Scotland's Fiscal Framework, 15 December 2015, pp 27-32
- IFS, Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options, November 2015. This research is also summarised in an IFS Observation.
- Scottish Parliament Finance Committee. Scotland's Fiscal Framework, 29 June 2015, SP Paper 771

The agreement reached

Block grant adjustment was the final part of the fiscal framework to be agreed. Negotiations had reached a stalemate with each side advocating a different method, each of which emphasised different no detriment principles from the Smith Commission.[92]

The Scottish Government's preferred method appeared to better meet the Smith Commission's principle that there should be 'no detriment as a result of the decision to devolve further powers'. The UK

92 SP OR DC 23 February 2016

Government's preferred method appeared to better meet the 'taxpayer fairness' principle. [93]

With no method existing that would meet both principles, the negotiations had become stuck. Agreement was reached through compromise:

- for a transitional period – to March 2022 – the Treasury's preferred method of block grant adjustment[94] will be used, but an annual reconciliation process will ensure that the result is the same as would have been reached if Scottish Government's preferred method were used[95]
- towards the end of the transitional period, the two Governments will review the procedure – informed by an independent review – and decide on how the block grant is to be adjusted after the transitional period

The agreed framework also states that the initial block grant adjustment for tax will be equal to the UK government's receipts generated from Scotland in the year immediately prior to the devolution of powers. [96]

2.3 Borrowing

Replacing some of the block grant – a relatively predictable source of revenue – with less predictable tax revenues will impart volatility to the Scottish public finances. The Smith Commission suggested that the Scottish Government should receive further revenue borrowing powers to manage the fiscal risks resulting from tax devolution. The Smith Commission recommended that the Scottish Government should have sufficient:

> [...] additional borrowing powers to ensure budgetary stability and provide safeguards to smooth Scottish public spending in the event of economic shocks, consistent with a sustainable overall UK fiscal framework. [97]

The Commission also said that the Scottish Government should have sufficient borrowing powers to support capital investment. [98]

The Command Paper said that the Scottish Government requires additional revenue borrowing powers that reflect the risks taken on in the final devolution settlement. The precise risks, and the tools required to manage the risk, will depend on the funding model agreed in the fiscal

93 Further discussion of the UK and Scottish Government's preferred options is available in the IFS's Observation Adjusting Scotland's block grant – the options on the table and the Centre on Constitutional Change's Adjusting Scotland's Block Grant - the options on the table
94 Comparable model – this is an adjusted form of their original preference 'levels deduction'. See the above IFS briefing for more on the different methods
95 Indexed Per Capita
96 HM Government & Scottish Government, The agreement between the Scottish Government and the United Kingdom Government on the Scottish Government's fiscal framework, February 2016, para 11
97 *Report of the Smith Commission*, November 2014 para 95(5)
98 ibid

framework.[99] How much risk the Scottish Government takes on in the block grant adjustments will be a key consideration. There has been broad agreement with this view.[100]

The agreement reached

Scotland's new fiscal framework increases the Scottish Government's capital borrowing cap to a cumulative total of £3 billion, up from £2.2 billion. It will be able to borrow £450 million annually for capital investment, subject to the cap.[101]

The Scottish Government will be able to borrow a cumulative total of £1.75 billion for resource purposes, up from £0.5 billion. Annually it will be able to borrow up to £600 million for the following reasons:

- up to £500 million for in-year cash management
- up to £300 million for forecast error
- up to £600 million to manage economic shocks

Borrowing for economic shocks will be available when annual growth in Scottish GDP is less than 1% and is also 1% point below UK GDP growth. This applies to either actual growth data or forecasts. The borrowing will be available in the financial year in which it was triggered and the two following years.[102]

The borrowing powers will apply from 2017/18.

Box 2: Scottish Government's current borrowing powers

The Scottish Government received additional borrowing powers in April 2015 following introduction of the Scotland Act 2012. The Act also allows the UK Government to extend these powers further without the need for primary legislation.[103]

Revenue borrowing

To deal with unexpected shortfalls in tax revenues the Scottish Government is able to borrow up to £200 million a year with a cumulative limit of £500 million. The Treasury will provide loans for a maximum of 4 years. The UK Government can revise the borrowing limit up or down, but may not take it below its initial £500 million level.

The Scottish Government can also operate a cash reserve.[104]

Capital borrowing

The Scottish Government can borrow to support capital investment, subject to a cumulative 10-year cap of £2.2 billion. Annual borrowing is limited to 10% of Capital Departmental Expenditure Limit (DEL).[105]

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99 HM Government, Scotland in the United Kingdom: An enduring settlement, para 2.4.20 – 2.4.23

100 See for instance: Scottish Parliament Finance Committee, Scotland's Fiscal Framework, SP Paper 771, 29 June 2015, para 40 and para 58; Treasury Committee, *Proposals for further Fiscal and Economic Devolution to Scotland,* Oral evidence, 4 November 2014, HC 760; ibid, Q123; and, Treasury Committee, *Proposals for further Fiscal and Economic Devolution to Scotland,* Oral evidence, 20 January 2015, HC 760, Q282

101 HM Government & Scottish Government, The agreement between the Scottish Government and the United Kingdom Government on the Scottish Government's fiscal framework, February 2016, para 54-60

102 ibid, paras 61-70

103 Scotland Act 2012 explanatory notes

104 Scotland Office, Third Annual Report on the Implementation and Operation of Part 3 (Financial Provisions) of the Scotland Act 2012, March 2015, Chapter 6

105 A definition of DEL is available from HM Treasury.

The UK Government can revise the borrowing limit up or down, but not below its initial £2.2 billion level.

The Scottish Government can borrow for capital investment from the National Loans fund or commercial banks. Scottish Ministers can also issue bonds to finance capital investment.[106]

2.4 No detriment: Policy decisions post-devolution

As well as taxpayer fairness, the Smith Commission's second no detriment principle addressed policy decisions taken by either Government after devolution:

> Where either the UK or the Scottish Governments makes policy decisions that affect the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving. There should be a shared understanding of the evidence to support any adjustments. [107]

The Command Paper said that both direct and behavioural effects need to be considered. Examples were provided to explain the principle: [108]

- **Benefits paid net of income tax –** some benefits are paid net of income tax, so if the Scottish Government changes income tax in Scotland, this will have a direct impact on the level of benefits that the UK Government will be liable to pay. Under this 'no detriment' principle, the Scottish Government would receive any savings from lower UK Government benefit spending or meet any costs of higher UK Government benefit spending.
- **Benefits used for passporting** – one government may change the eligibility criteria for a benefit that is used as a passport benefit by the other government. In this case the increased spend on the benefit passported to would be met by the government making the change (or they would receive any savings). For example, awards of the higher rate mobility component of Disability Living Allowance and the enhanced rate mobility component of Personal Independence Payment can serve as a 'passport' to entitlement to reductions in Vehicle Exercise Duty (VED) and VAT on long-term leases of vehicles and relevant equipment (and in some other areas). While DLA/PIP will be devolved in full to the Scottish Parliament, VED and VAT will remain reserved to the UK Parliament. If the Scottish Government changes eligibility criteria for disability benefits, it will be responsible for the resulting impact on the UK Government's VED and VAT revenues.

106 Scotland Office, Third Annual Report on the Implementation and Operation of Part 3 (Financial Provisions) of the Scotland Act 2012, March 2015, Chapter 6
107 *Report of the Smith Commission*, November 2014para 95(4a)
108 HM Government, Scotland in the United Kingdom: An enduring settlement, para 2.4.16

Discussion of no detriment from policy decisions

The IFS suggests that whilst reimbursement is a sensible approach – making sure each government should bear the full costs of its policy decisions – in many cases it may be difficult to implement:

> Nearly all policy decisions could have knock on effects on the revenues or spending of the other government. But calculating what these are is inherently difficult, with much room for disagreement over the methods and assumptions used. This means it is important to recognise that such compensating transfers will be practical only in a few simple cases – otherwise the system could quickly become unworkable.[109]

The Lords Committee on Economic Affairs felt that the no detriment principle is "unworkable in practice and a recipe for continuing conflict".[110] The Scottish Government's evidence to the Committee in August 2015 was that the principle was "not well defined" and they were working with the UK Government to clarify its meaning and application.[111]

The Scottish Parliament's Finance Committee recommended that the no detriment principle should be treated as "a high level principle to guide the governments in the application of the fiscal framework and in adjusting the block grant". Applying the principle as a mechanical rule risks, in the Committee's opinion, disagreement and dispute. The Committee recommended that the principle be better defined, and any decisions reached on it by the JEC be made public. [112]

The agreement reached

The UK Government and Scottish Governments agree, in the new fiscal framework, that direct spillover effects – those which directly and mechanically exist as a result of policy changes – should be reimbursed. Behavioural spillover effects – those which come about from people changing their behaviour because of a policy – will be accounted for in exceptional circumstances, where the savings or costs are 'material' and 'demonstrable':

> Behavioural effects that involve a material and demonstrable welfare cost or saving will be taken into account where these are in exceptional circumstances. Behavioural effects that impact tax revenues can be taken into account where, in exceptional circumstances, they are demonstrated to be material and both governments agree that it is appropriate to do so.[113]

Both Governments must agree to any reimbursements – without an agreement no transfer will be made. Spillover effects will first be discussed by officials of the two Governments. If agreement can't be

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[109] IFS, *The Smith Commission's Proposals*, December 2014, page 17
[110] House of Lords Committee on Economic Affairs, A Fracturing Union? The Implications of Financial Devolution to Scotland, 1st Report of Session 2015-16, HL Paper 55, 20 November 2015 , para 49 - 57
[111] ibid para 55
[112] Scottish Parliament Finance Committee, Scotland's Fiscal Framework, 2015, para 100 – 103
[113] HM Government & Scottish Government, The agreement between the Scottish Government and the United Kingdom Government on the Scottish Government's fiscal framework, February 2016, para 50

reached the issue will move onto Ministers at the JEC. If agreement can't be reached at the JEC a dispute can be raised – the fiscal framework includes guidance on dispute resolution.[114]

2.5 What else does the new fiscal framework say?

Adjusting the block grant for welfare powers

When a welfare power is devolved there will be an initial adjustment (an increase) to the block grant equal to the UK Government's spending on the area in Scotland in the year prior to the devolution of power. An exception will be made for Cold Weather Payment: because of the volatility of this benefit, the initial adjustment will reflect the UK Government's average spending in Scotland from 2008/09.[115]

The Barnett formula will then be used to calculate changes in funding for the devolved welfare spending in future years.[116] However, during the transitional period to 2021/22 – as with block grant adjustment for tax powers – a reconciliation will take place to achieve the Scottish Government's preferred indexing method.[117]

A Joint Ministerial Working Group on Welfare will decide when welfare powers will be devolved.[118]

Adjusting the block grant for spending powers

When a spending power is devolved the full costs of the programme in Scotland will be transferred for the rest of the Spending Review period. The Barnett formula will then apply to changes in UK government spending on the area.[119]

Administration and implementation costs

The Scottish Government will received £200 million to support the implementation of new powers. This is a one-off payment, the timing of which is to be agreed by the JEC.[120]

The Scottish Government's ongoing administration costs from devolved powers will be met by a transfer of £66 million that will be indexed by the Barnett formula.[121]

VAT assignment

The Scottish Government will be assigned half of VAT receipts raised in Scotland, based on an estimate of expenditure in Scotland on goods and services that are liable for VAT. The two Governments have agreed that VAT receipts will be assigned from 2019/20.

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[114] ibid, paras 98 - 104
[115] HM Government & Scottish Government, The agreement between the Scottish Government and the United Kingdom Government on the Scottish Government's fiscal framework, February 2016, para 13
[116] ibid, para 16
[117] ibid, para 17
[118] ibid, para 29
[119] ibid, para 8
[120] ibid, para 31
[121] ibid, para 32

The method for estimating VAT expenditure in Scotland hasn't yet been agreed. Officials from HMRC and the Scottish Government are developing a methodology which will require sign-off by the Joint Exchequer Committee.

The methodology is to be tested during a transitional period, but with no impact for the Scottish Government's budget.[122]

Scotland Reserve

From 2017/18 a Scotland Reserve will be introduced. The Scottish Government will be able to hold up to £700 million in the reserve and will annually be able to take £250 million and £100 million out of it for resource and capital respectively. Annual withdrawal limits will be removed if there is an economic shock in Scotland.

The Reserve is to be used to smooth spending and manage tax volatility.[123]

Independent Fiscal Scrutiny

The Smith Commission recommends that the Scottish Parliament should 'expand and strengthen the independent scrutiny of Scotland's public finances'.[124] This potentially meant a strengthening of the role of the non-statutory Scottish Fiscal Commission (SFC) or an expansion of the UK's Office for Budget Responsibility's role.

The SFC currently reviews Scottish Government forecasts of receipts from the devolved Land and Buildings Transaction Tax and the Scottish Landfill Tax, and scrutinises the economic determinants underpinning forecasted receipts from non-domestic rates.[125]

The Scottish Government has recently introduced the Scottish Fiscal Commission Bill[126] to the Scottish Parliament which would place the SFC on a statutory basis, independent of government. The SFC's role would expand to cover scrutiny of the Scottish Government's future borrowing projections.

The new fiscal framework says that the SFC's role will be expanded further to reflect the powers being devolved in the Scotland Bill and the fiscal framework. The SFC and OBR will work together to scrutinise Scotland's public finances. Working arrangements will be set out in a Memorandum of Understanding.[127]

Forecasts

The Scottish Fiscal Commission will produce forecasts of Scottish:

- demand driven welfare spending;
- revenues from the fully devolved taxes and income tax; and,
- onshore GDP.

[122] Ibid, paras 40 -43
[123] ibid paras 71-78
[124] *Report of the Smith Commission*, November 2014 para 95(7)
[125] Scottish Fiscal Commission, Report by Scottish Fiscal Commission, 9 October 2014
[126] Scottish Fiscal Commission Bill
[127] op cit paras 79-83

The OBR will continue to produce forecasts for the whole of the UK, as well as forecasts of UK government tax and spending required for the operation of the fiscal framework.

Which organisation produces forecasts of VAT revenues is yet to be agreed.[128]

2.6 Agreement and negotiation of the fiscal framework

On 23 February 2016, Scotland's First Minister, Nicola Sturgeon MSP, gave an urgent statement to the Scottish Parliament reporting that an agreement on the fiscal framework had been reached, at least in principle.[129] The UK Government also acknowledged the agreement.[130]

Earlier on the same day the First Minister made another statement in which she said that only one area of the fiscal framework was still left to be agreed: how Scotland's main source of revenue – the block grant (see Box 1) – would be adjusted to reflect the extra revenue it will raise from the taxes being devolved.[131] Negotiations during the day, including between the First Minister and Chancellor of the Exchequer, reached an agreement.[132]

Negotiations at the Joint Exchequer Committee

In the main the Joint Exchequer Committee (JEC), made up of representatives of the UK and Scottish Governments, negotiated the fiscal framework.

The JEC met ten times between July 2015 and February 2016. Communiques were published after each meeting summarising the broad topics discussed without going into any great detail.[133]

The communiques say that the JEC considered:

- issues relating to the block grant adjustment
- ensuring that neither Government's budget is adversely affected simply from the decision to devolve power, or from policy decision taken by the other after devolution. These are often described as Smith's 'no detriment principles' and are discussed in Box 2

128 ibid, paras 84-88
129 SP February 23 2016
130 Prime Minister's Office Press Release, *PM statement on the fiscal framework for Scotland: 23 February 2016*, 23 February 2016; and, HM Treasury, *Historic new Scotland funding deal agreed*, 23 February 2016
131 SP February 23 2016
132 HM Treasury & Scottish Government, The agreement between the Scottish government and the United Kingdom government on the Scottish government's fiscal framework, 25 February 2016
133 All from HM Treasury: Joint Exchequer Committee Communique 7 July 2015; Joint Exchequer Committee: 4 September 2015; Joint Exchequer Committee: 23 September 2015; Joint Exchequer Committee: 9 October 2015; Joint Exchequer Committee: 7 December 2015; Joint Exchequer Committee: 8 January 2016; Joint Exchequer Committee: 21 January 2016; Joint Exchequer Committee: 1 February 2016; Joint Exchequer Committee: 8 February 2016; Joint Exchequer Committee: 19 February 2016

- administration and operation costs associated with the Smith Commission
- the methodology for assigning VAT revenues
- roles of the Scottish Fiscal Commission and Office for Budget Responsibility in relation to devolved public finances
- revenue borrowing and ensuring that the Scottish Government has adequate flexibility to smooth public spending when economic shocks occur
- financial issues associated with complex items to be devolved, such as the Crown Estate and Employability Programmes
- structure and outline content of the fiscal framework and its future governance
- initial transfer for new welfare powers

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