



The Scottish Parliament
Pàrlamaid na h-Alba

Finance Committee
6th Report, 2015 (Session 4)
Further Fiscal Devolution

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Pàrlamaid na h-Alba

Finance Committee

Remit and membership

Remit:

1. The remit of the Finance Committee is to consider and report on-

(a) any report or other document laid before the Parliament by members of the Scottish Government containing proposals for, or budgets of, public expenditure or proposals for the making of a tax-varying resolution, taking into account any report or recommendations concerning such documents made to them by any other committee with power to consider such documents or any part of them;

(b) any report made by a committee setting out proposals concerning public expenditure;

(c) Budget Bills; and

(d) any other matter relating to or affecting the expenditure of the Scottish Administration or other expenditure payable out of the Scottish Consolidated Fund.

2. The Committee may also consider and, where it sees fit, report to the Parliament on the timetable for the Stages of Budget Bills and on the handling of financial business.

3. In these Rules, "public expenditure" means expenditure of the Scottish Administration, other expenditure payable out of the Scottish Consolidated Fund and any other expenditure met out of taxes, charges and other public revenue.

(Standing Orders of the Scottish Parliament, Rule 6.6)

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Gavin Brown

Malcolm Chisholm

Kenneth Gibson (Convener)

Jamie Hepburn (until 25 November 2014)

John Mason (Deputy Convener)

Mark McDonald (from 26 November 2014)

Michael McMahon (until 13 January 2015)

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Committee Assistant

Tom Williams



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Further Fiscal Devolution

The Committee reports to the Parliament as follows—

INTRODUCTION

1. The Committee agreed at its meeting on 8 October 2014 to undertake an inquiry into further fiscal devolution. The Committee considered both the options for the devolution of further financial powers and a number of implementation issues. The Committee's Adviser drafted a summary of the evidence received in relation to the taxes considered by the Smith Commission and this is attached as Annexe A. The main body of the report focuses on implementation issues and builds on the previous work of the Committee in scrutinising the implementation of the financial powers within the Scotland Act 2012.
2. The Committee published a call for evidence on 8 October and received 23 submissions.¹ The Committee also held a number of oral evidence sessions including with the Chief Secretary to the Treasury (CST) and the Cabinet Secretary for Finance, Constitution and Economy ("the Cabinet Secretary"). The Committee would like to thank everyone who gave evidence to the inquiry.
3. The Committee has also published a call for evidence² on the proposals for a fiscal framework for Scotland recommended by the Smith Commission³ and set out in more detail in the UK Government Command paper, *Scotland in the United Kingdom: An enduring settlement*.⁴
4. It is intended that the findings in this report will help to inform the Committee's consideration of the proposed fiscal framework.

Scotland's Fiscal Framework

5. The Smith Commission recommends that the "devolution of further responsibility for taxation and public spending, including elements of the welfare

¹<http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/83965.aspx>

²<http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/86486.aspx>

³http://www.smith-commission.scot/wp-content/uploads/2014/11/The_Smith_Commission_Report-1.pdf

⁴<https://www.gov.uk/government/publications/scotland-in-the-united-kingdom-an-enduring-settlement>

system, should be accompanied by an updated fiscal framework for Scotland, consistent with the overall UK fiscal framework.” The UK and Scottish Governments should jointly work via the Joint Exchequer Committee (JEC) to agree the framework which should include:

- Funding of the Scottish budget;
- Adjustments to the block grant arising from further devolution;
- Operation of borrowing powers and cash reserve;
- Fiscal rules;
- Independent fiscal institutions.

6. Chapter 2 of the UK Government’s command paper sets out its view on the proposed fiscal framework for Scotland. It defines a fiscal framework as the “set of rules and institutions that are used to set and coordinate sustainable fiscal policy.”⁵ Two key elements are identified: fiscal rules and fiscal institutions.

7. The Command paper states that the new fiscal framework “will be agreed and implemented jointly by the UK Government and Scottish Government through the Joint Exchequer Committee, with suitable engagement with both the UK and Scottish Parliaments.”⁶

8. The CST anticipates that “the framework will be established early in the next UK Parliament, alongside the introduction of a debate on the proposed legislation in the House of Commons.”⁷ The Cabinet Secretary’s view is that the “negotiations on the fiscal framework will be more complex than those on the block grant adjustment for the Scotland Act 2012, although we can build on that experience.” In response from questioning from the Committee he agreed that a defined timescale for the negotiations on the fiscal framework would “probably help” and that it should be tied to the “enactment of the legislation.”⁸

9. The Committee recommends that a clear timetable is agreed and published by the UK and Scottish Governments for the implementation of Scotland’s fiscal framework. This should include allowing sufficient time for consultation with both parliaments on a draft framework.

No Detriment

10. The Smith Commission recommended that there should be “no detriment” as a result of the decision to devolve further powers which means both Governments’ “budgets should be no larger or smaller simply as a result of the initial transfer of tax

⁵https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/397079/Scotland_EnduringSettlement_acc.pdf paragraph 2.2.3

⁶https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/397079/Scotland_EnduringSettlement_acc.pdf paragraph 2.4.37

⁷ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 24](#)

⁸ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 53](#)

and/or spending powers, before considering how these are used.”⁹ It also recommended that there should be no detriment to the budget of the other government “as a result of UK Government or Scottish Government policy decisions post-devolution.”¹⁰

11. The CST told the Committee:

“it is important that we have in the command paper some clear principles about how the fiscal framework within which the new system will operate will be governed. In particular, there is the no detriment principle, which in a sense ensures that there is no gain or loss as a consequence of the fact of devolution to either Scotland or the rest of the United Kingdom, but which confers proper responsibility to each to bear the consequences of actions determined here and actions determined in the UK Parliament.”¹¹

12. In response to questioning from the Committee in relation to the clarity of the no detriment principle the CST responded that “there is a lot of detail behind that, and that detail has still to be worked on, but the principles that are set down are clear.”¹² The Cabinet Secretary takes a different view. He argues that the principle is “not well defined at the moment” and “when we attempt to turn the principle into reality, we will have a few years like those we had with the block grant adjustment.”¹³

13. The Committee notes that there are clear differences between the two Governments regarding the clarity of the no detriment principle. The Committee intends to take further evidence on this issue as part of its forthcoming inquiry on the fiscal framework.

Gaming

14. Professor Heald has highlighted to the Committee on a number of occasions that the new tax powers may be vulnerable to gaming by the UK Government. He warns, for example, that the UK Government “will not allow Scotland (or Wales or Northern Ireland) to erode its own tax base and the Treasury will have retaliatory instruments.”¹⁴ He also suggests that if:

“the UK Treasury does not have a financial stake in the Scottish income tax base, I would expect both malicious actions (eroding that base through other tax measures) and malign neglect (inadequate attention being paid to interactions with other tax measures and inadequate enforcement from HMRC

⁹ http://www.smith-commission.scot/wp-content/uploads/2014/11/The_Smith_Commission_Report-1.pdf paragraph 95(3)

¹⁰ http://www.smith-commission.scot/wp-content/uploads/2014/11/The_Smith_Commission_Report-1.pdf paragraph 95(4)

¹¹ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 2](#)

¹² [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 27](#)

¹³ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 46](#)

¹⁴ [http://www.scottish.parliament.uk/S4_FinanceCommittee/Meeting%20Papers/2014_11_05_Public_papers\(2\).pdf](http://www.scottish.parliament.uk/S4_FinanceCommittee/Meeting%20Papers/2014_11_05_Public_papers(2).pdf)

in the entirely new situation where determination of Scottish residence matters).¹⁵

15. In oral evidence to the Committee in June 2014 he suggested that “there must be some basis on which the Scottish Government, the Welsh Government and the Northern Ireland Executive can plan their use of the tax powers without concern that subsequent changes to the tax system at the UK level will compromise the operation of those powers”.¹⁶ The implementation of further tax powers in Scotland must be accompanied by “some mechanism for co-ordination between the UK level and the Scottish level.”¹⁷ One option suggested by the Law Society of Scotland is a financial fair play clause.

16. In response to questioning from the Committee on the idea of a fair play clause the CST stated that the “idea of fair play is one reason why the fiscal framework and the no detriment clause are so important.”¹⁸ However, he disagreed with Professor Heald’s argument that the operation of the devolved taxes are vulnerable to gaming by the UK Government suggesting there “is no evidence to support it.”¹⁹

17. The Cabinet Secretary takes a different view and suggests we have already seen an example of gaming. He cites the decision of the UK Government to change the rates and thresholds for Stamp Duty Land Tax (SDLT) in December 2014 following the publication in October 2014 of the Scottish Government’s proposed rates for Land and Buildings Transaction Tax (LBTT).²⁰

18. The Committee notes that there are clear differences between the two Governments regarding the question of gaming. The Committee recommends that the issue of gaming needs further consideration within the context of the no detriment principle.

Block Grant and Barnett Formula

19. The devolved administrations are primarily funded by a block grant and formula system. The Barnett Formula is used to calculate changes to the block grant and not the underlying baseline. Professor Trench notes that all “key decisions regarding the working of the formula and the block grant and formula system are taken by HM Treasury.”²¹ The formula is not enshrined in statute, or given any legal or constitutional form.

Barnett Formula

20. The Smith Commission recommended that “the block grant from the UK Government will continue to be determined via the operation of the Barnett Formula.” The UK Government Command paper states that consistent “with the

¹⁵[http://www.scottish.parliament.uk/S4_FinanceCommittee/Meeting%20Papers/2014_11_05_Public_papers\(2\).pdf](http://www.scottish.parliament.uk/S4_FinanceCommittee/Meeting%20Papers/2014_11_05_Public_papers(2).pdf)

¹⁶ [Scottish Parliament Finance Committee, Official Report, 25 June 2014, Col 4517-4518](#)

¹⁷ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 19](#)

¹⁸ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 12](#)

¹⁹ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 13](#)

²⁰ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 54](#)

²¹ <https://devolutionmatters.wordpress.com/the-barnett-formula-and-the-financing-of-devolution/>

commitment made by all three main UK-wide party leaders, the Barnett formula will continue.”²²

21. Professor Heald has previously questioned in written evidence to the Committee what is meant by retaining the formula. He asks whether this means one or more of the following:

- That the Barnett name will be kept;
- That the population-based adjustment mechanism will continue, whether or not in combination with needs assessment; and/or
- That Scotland’s per capita public expenditure will be maintained.

22. Professor Kay argues that the Barnett Formula is “now inevitably under pressure” and will “generate resistance and resentment in a way that it has not done in the past.”²³ Professor Bell and David Eiser point out that the formula has “been extensively criticised on several grounds” including that it:

- takes no account of the relative spending needs across the UK;
- is based on policy changes in England;
- lacks transparency in how it is operated by the UK Treasury.

23. Professor Bell suggests that the formula “might come under more pressure if there is a substantially greater income tax take in Scotland, and I suspect that there will be pressure from outside Scotland because it is unpopular outside Scotland.”²⁴ Professor Holtham provided a written submission to the Committee in June 2014 in which he states that since the formula “is entirely arbitrary and without any reasoned justification some sort of reform would be appropriate.”²⁵

24. Professor Heald suggests that “we need a debate about how the block grant works” including a “serious discussion about the population adjustment mechanism versus a regular needs assessment.”²⁶ He also questions the assumption that the block grant will become less important as more fiscal powers are devolved. He suggests in written evidence that “the size of the block grant indicates the level of Scottish spending that the UK Government is willing to underwrite.”

25. The CST pointed out that there is a political consensus regarding the Barnett formula which suggests “widespread support for continuing it long into the future.”²⁷ He also advised that there “are no proposals from the UK Government – and I am

²² https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/397079/Scotland_EnduringSettlement_acc.pdf paragraph 2.4.2

²³ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 15](#)

²⁴ [Scottish Parliament Finance Committee, Official Report, 8 October 2014, Col 9](#)

²⁵ http://www.scottish.parliament.uk/S4_FinanceCommittee/Meeting%20Papers/FC_Public_papers_25_June%283%29.pdf

<http://www.scottish.parliament.uk/parliamentarybusiness/28862.aspx?r=9611&mode=pdf>

²⁶ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 16](#)

²⁷ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 6](#)

not aware of any from any political party – to change any aspect of how the Barnett formula operates.”²⁸

26. The CST also suggested that following the devolution of the Smith Commission recommendations, the block grant determined by the Barnett formula will be responsible for around 35% of the expenditure undertaken by the Scottish Government.²⁹ However, when this figure was put to the Cabinet Secretary he responded that the “highest number I could get devolved and assigned taxes to as a percentage of expenditure in Scotland, taking into account all the changes under Smith, would be 48 per cent. That would leave the block grant at 52 per cent.”³⁰

27. The Committee has written to both the CST and the Cabinet Secretary seeking clarification of how their respective figures were calculated.

Transparency

28. A number of witnesses raised concerns regarding the lack of transparency in relation to how the block grant is calculated. Professor Heald suggested to the Committee in written evidence in June 2014 that there “is a transparency deficit that is undesirable now and – unless removed – would make major devolved taxes unworkable.”³¹

29. Professor Trench also informed the Committee in June that there are “very strong reasons to change the way the grant is administered and organised, so that fewer decisions are taken unilaterally by HM Treasury, there is greater transparency about the working of the formula and the funds allocated using it, and there is greater scope for impartial intervention and review of decisions about the formula.”³²

30. Professor McLean points out that “how the Barnett formula works is entirely in the hands of HM Treasury; it is not a statutory matter. If the Scottish Parliament or the Scottish Government does not like what HM Treasury is doing, there are...no mechanisms to pursue that, except perhaps the joint ministerial committee.”³³ He suggests that the block grant should be determined by a public body “under the joint control of, say, the Scottish, Northern Irish, Welsh and UK Parliaments.”³⁴ One possible model would be the Commonwealth Grants Commission in Australia.

31. While the CST recognised that the operation of the Barnett formula can be quite complicated he disagreed that there is a lack of transparency in the way in which it works. He also pointed out that apart from a mathematical error he couldn't recall any disagreement with the devolved administrations about the operation of the formula. He advised the Committee that the “operation of the Barnett formula is a technocratic process and the outcome of the mathematical calculations can be and

²⁸ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 7](#)

²⁹ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 3](#)

³⁰ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 38](#)

³¹ http://www.scottish.parliament.uk/S4_FinanceCommittee/Meeting%20Papers/FC_Public_papers_25_June%283%29.pdf

³² http://www.scottish.parliament.uk/S4_FinanceCommittee/Meeting%20Papers/FC_Public_papers_25_June%283%29.pdf

³³ [Scottish Parliament Finance Committee, Official Report, 29 October 2014, Col 36](#)

³⁴ [Scottish Parliament Finance Committee, Official Report, 29 October 2014, Col 36](#)

is scrutinised by officials in the Scottish Government, the Welsh Government and the Northern Ireland Executive.”³⁵

32. The Committee notes that while there may be some discussion between the UK and Scottish Governments on the operation of the Barnett formula this is done in private and cannot be viewed as transparent.

33. The Committee’s view is that there is a need for much greater transparency and accountability in relation to how the block grant is calculated. The Committee intends to consider what mechanisms are required to ensure the transparency and accountability of how the block grant is calculated as part of its forthcoming inquiry on the fiscal framework.

Block Grant Adjustment

34. The Smith Commission recommended that “the initial devolution and assignment of tax receipts should be accompanied by a reduction in the block grant equivalent to the revenue foregone by the UK Government, and that future growth in the reduction to the block grant should be indexed appropriately.”³⁶

35. The Chartered Institute of Taxation (CIT) stated in written evidence that “in respect of the block grant, it is important that the formula for reduction is transparent. Additionally, there must be co-ordination between the UK and Scottish Governments in relation to taxes.” The Law Society of Scotland’s view is that “there ought to be more of an agreed timetable for reaching agreement on the adjustment to the block grant.”³⁷

36. The Committee has repeatedly raised concerns in relation to the transparency and timings of changes to the block grant arising from further fiscal devolution. In its report on Draft Budget 2015-16 the Committee emphasised that there needs to be much greater transparency from both the UK Government and the Scottish Government and that sufficient time is made available to allow effective parliamentary scrutiny of adjustments to the block grant prior to implementation.

37. The Cabinet Secretary recognises in his response to the Committee that “a key requirement of any block grant adjustment is that it is transparent and that the Parliament can agree to it.” He also states that he “will take forward the issues raised by the Committee when seeking a permanent block grant adjustment mechanism.”³⁸ The clerks are also working with Scottish Government officials to bring forward any necessary changes to the Written Agreement.

38. The CST stated that “it is important to have an adjustment mechanism that is transparent and able to operate automatically as far as possible.”³⁹

³⁵ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 7](#)

³⁶ http://www.smith-commission.scot/wp-content/uploads/2014/11/The_Smith_Commission_Report-1.pdf

³⁷ [Scottish Parliament Finance Committee, Official Report, 10 December 2014, Col 13](#)

³⁸ [http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/Cabinet_Secretary_for_Finance_Constitution_and_Economy_to_Convener_dated_3_February_2015\(1\).pdf](http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/Cabinet_Secretary_for_Finance_Constitution_and_Economy_to_Convener_dated_3_February_2015(1).pdf)

³⁹ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 10](#)

39. The two Governments also agreed through the JEC a set of principles for making adjustments to the block grant and these are attached as Annexe B.

40. **The Committee asks the Scottish Government how useful these principles were in informing the negotiations on the adjustment to the block grant arising from the Scotland Act 2012 and whether there is any plan to review them.**

41. **The Committee also recommends the need to develop a more robust framework for considering future adjustments to the block grant which should be made public.**

Constraining Factor

42. The Committee also heard from the Cabinet Secretary during the draft budget process that the UK Government has sought to include a “constraining factor” within the block grant adjustment. This means attempting to calculate up to about 2029 or 2030 what the devolved taxes would generate and adjust the block grant on this basis so that neither the UK or the Scotland would be better or worse off. The Committee agreed with the Cabinet Secretary that this totally defeats the point of devolving the taxes.

43. In response to questioning from the Committee on the proposal for a constraining factor the CST pointed out that “that work was done as an aid to understanding which of the sets of numbers was likely to be more accurate, to inform how the adjustment works.”⁴⁰

44. However, the Cabinet Secretary told the Committee, the “Treasury proposed what was an essentially a constrained model. We would try to predict stamp duty until 2029-30, which would specify how much tax we envisage would be raised, and then we could calculate an index mechanism that would enable Scotland to be no better or no worse off after all that calculation out to 2029-30.”⁴¹ He rejects this as an “absurd proposition” but warns that the constraining factor may be raised again by the UK Government in discussions on the fiscal framework and the no detriment principle.⁴²

45. The Committee agreed with the Cabinet Secretary in its report on the Draft Budget 2015-16 that the inclusion of a constraining factor “totally defeats the point of devolving the taxes.”⁴³ The Cabinet Secretary responded that “it should be the case for all future block grant adjustment mechanisms that the Scottish budget should benefit if devolved taxes perform better than if the taxes had not been devolved.”⁴⁴

46. The CST was also asked by the Committee whether he agreed that a constraining factor “defeats the point of devolving the taxes”. He responded that “I agree with you on that. The framework is designed to ensure, exactly as you say, that if the Scottish Parliament makes decisions that are beneficial and lead to higher

⁴⁰ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 18](#)

⁴¹ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 45](#)

⁴² [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 46](#)

⁴³ http://www.scottish.parliament.uk/S4_FinanceCommittee/Reports/fiR-15-01w.pdf paragraph 65

⁴⁴ [http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/Cabinet_Secretary_for_Finance_Constitution_and_Economy_to_Convener_dated_3_February_2015\(1\).pdf](http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/Cabinet_Secretary_for_Finance_Constitution_and_Economy_to_Convener_dated_3_February_2015(1).pdf)

tax revenues over time, that should benefit the resources that are available to the Scottish Government.”⁴⁵

47. The Committee will write to the CST asking him to confirm that there is no intention to include a constraining factor within any adjustment to the block grant and that any attempt to do so would be inconsistent with the no detriment principle.

Statement of Funding Policy

48. The purpose of HM Treasury’s Statement of Funding Policy (SFP) is “to set out the policies and procedures, which underpin the exercise of setting the budgets of the devolved administrations.”⁴⁶ The Statement is agreed between the Chief Secretary to the Treasury and the Secretaries of State for Scotland, Wales and Northern Ireland following consultation with the devolved administrations.⁴⁷ It is, therefore, a UK Government document and does not have to be agreed by the devolved administrations. The Statement has not been revised since 2010 and, therefore, does not include any reference to the arrangements for implementing the financial powers within the Scotland Act 2012.

49. Professor Trench questions why “our financing system essentially depends on an informal Treasury document that the Treasury drafts on its own.”⁴⁸ He argues that “the Treasury was not merely judge in its own cause, with a jury from its side of the fence, but it wrote the rules as well!”⁴⁹ He suggests that at “the very least, there needs to be an impartial mediator” and that the devolved administrations should have a role in drafting and agreeing a revised Statement.

50. The SFP states that the UK Government recognises “it may need to be revised” in response to the implementation of the proposals of the Calman Commission.

51. The CST was asked why the SFP has not been updated since 2010 and his officials responded that there was mutual agreement with the Scottish Government that the “sensible time to update the funding policy would probably be in advance of the next spending round.”⁵⁰ He also confirmed that the devolved administrations would be consulted on any changes.

52. The Committee asks why the SFP has not been updated since 2010 to include, for example, the principles for agreeing adjustments to the block grant.

⁴⁵ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 9](#)

⁴⁶ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 9](#) paragraph 2.2

⁴⁷ http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/sr2010_fundingpolicy.pdf

⁴⁸ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 38](#)

⁴⁹ <https://devolutionmatters.wordpress.com/>

⁵⁰ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 35](#)

Inter-Governmental Machinery

53. The Smith Commission states that “the current inter-governmental machinery between the Scottish and UK Governments, including the Joint Ministerial Committee (JMC) structures, must be reformed as a matter of urgency and scaled up significantly to reflect the scope of the agreement arrived at by the parties.” It also states that “parallel, formal processes should be developed for the Scottish Parliament and UK Parliament to collaborate more regularly in areas of joint interest in holding respective governments to account.” There should be much stronger and more transparent parliamentary scrutiny, for example, through the “pro-active reporting to respective Parliaments” of the conclusions of the JMC and the JEC.

54. The Scottish and UK Governments have previously agreed to provide the minutes of the JEC meetings to the Scottish Parliament (through the Finance Committee) and to the UK Parliament (through the Scottish Affairs Committee). However, the JEC has not met since February 2013.

55. The Cabinet Secretary stated that the experience of the JEC, “which was added to the arrangements post Calman to try to resolve some of the financial issues, has failed. It has proved no useful function in relation to the agreement for the block grant adjustment.”⁵¹

Finance Ministers’ Quadrilateral (FMQ) Meeting

56. ICAS recommended in their submission to the Smith Commission that as “proposed by the Calman Commission, consideration should also be given to enhancing the present FMQ meeting or similar to incorporate representatives of the devolved jurisdictions and that the scope of its discussions should be widened to cover not just expenditure but also taxation and macro-economic issues.”⁵² This last met in November 2013.

57. The Cabinet Secretary pointed out that most “business is transacted bilaterally” and that the JMC and JEC and “even to an extent” the FMQ “are a bit formal and mechanical” and not “particularly meaningful.”⁵³

58. The Cabinet Secretary was asked by the Committee about the transparency and accountability of informal arrangements between the two governments. He responded that “I try to ensure that the Committee is advised of as much information as I can provide as timeously as I can provide it about the sequence of measures that we are taking.”⁵⁴ He also stated that there is a “general point about accountability and transparency, which given the sensitivity of the issues that we are now dealing with, has to be reflected strongly by both Governments.”⁵⁵

59. The Committee agrees with the Smith Commission that there needs to be much stronger and more transparent parliamentary scrutiny of inter-governmental relations as more powers are devolved to Holyrood. However,

⁵¹ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 41](#)

⁵² [http://www.scottish.parliament.uk/S4_FinanceCommittee/Meeting%20Papers/Papers_for_the_public\(2\).pdf](http://www.scottish.parliament.uk/S4_FinanceCommittee/Meeting%20Papers/Papers_for_the_public(2).pdf)

⁵³ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 41](#)

⁵⁴ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 41](#)

⁵⁵ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 41](#)

given the apparent emphasis on informal bilateral relations rather than formal mechanisms there are issues around transparency and accountability which need to be addressed.

60. The Committee notes that the JEC has not met since February 2013 and that in the Cabinet Secretary's view it has failed. The Committee also notes the observation of the Cabinet Secretary that most business is transacted bilaterally and outwith the formal machinery of the JMC and JEC. This emphasis on informality provides challenges in delivering the Smith Commission recommendation that there should be much stronger and more transparent parliamentary scrutiny.

61. The Committee will take further evidence on how the inter-governmental machinery including the JEC be strengthened and made more transparent. In particular, the Committee will examine good practice in other fiscal federations and will invite SPICe to provide a comparative analysis. The Committee will also consider how we can ensure effective parliamentary scrutiny if most inter-governmental business is transacted outwith these formal mechanisms.

Scottish Fiscal Commission (SFC)

62. The Smith Commission recommended that the Scottish Parliament should seek to expand and strengthen the independent scrutiny of Scotland's public finances.

63. ICAS support the establishment of a Scottish Office of Budget Responsibility (or significant enhancement of the role and resources of the SFC) to improve the scrutiny and accountability of the Scottish Parliament in relation to fiscal powers.

64. The Scottish Government states in its programme for government that:

"The Scottish Fiscal Commission currently operates on a non-statutory basis. We will develop legislation to put the Commission on a statutory footing, and it is intended that such a Bill would allow for the functions and duties of the Commission to be reviewed and expanded in future. The Scottish Government proposes that the remit of the Scottish Fiscal Commission should expand to reflect any new fiscal powers devolved to the Scottish Parliament."⁵⁶

65. The Finance Committee has recommended that the SFC adheres to the OECD principles for independent fiscal institutions and "in particular, the principles of independence, non-partisanship and transparency."⁵⁷ The Committee also recommended that "it is essential that the SFC should be independent and seen to be so."⁵⁸ The Scottish Government agreed with these recommendations in its response to the Committee's report. It believes that the "independence of the SFC is

⁵⁶ <http://www.scotland.gov.uk/Resource/0046/00464455.pdf> page 44

⁵⁷ <http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/72938.aspx> paragraph 9

⁵⁸ <http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/72938.aspx> paragraph 8

essential” and intends that the SFC will adhere to the OECD principles both initially on a non-statutory basis and once established on a statutory basis.⁵⁹

66. The UK Government Command paper states that “it will be crucial that the remit and capacity of the” SFC fully reflects the devolution of further powers. The UK Government’s view is that the Scottish Government “should bring forward proposals fully consistent with the OECD principles, and reflecting the UK experience with the OBR, to enhance” the SFC “as part of agreement to a new fiscal framework for Scotland.”⁶⁰

Forecasting

67. The Committee heard conflicting views from the CST and the Cabinet Secretary in relation to who should have responsibility for economic forecasting including tax receipts. The CST suggested that the SFC should be given similar responsibilities to the OBR in relation to economic forecasting. This would mean that the SFC would have responsibility for originating the forecasts rather than commenting on Scottish Government forecasts. He stated that “having forecasts generated independently offers you the opportunity to give greater scrutiny to what the Scottish Government then decides to do.”⁶¹ He also believes that the SFC should forecast the receipts for the Scottish rate of income tax.

68. The Cabinet Secretary stated that the “current arrangements are entirely satisfactory” and the SFC “has a veto over my forecasts.”⁶² He also suggested in relation to the OBR forecasts that “HMRC does most of the work behind the scenes and gives the data to the OBR, which does not do anything with them that is much different from what” the SFC “does with the numbers.”⁶³

69. HMRC stated that “although the OBR has been praised for its independence, from our perspective, the process feels very much the same as it was when the Treasury was doing the forecasting – we had the same conversations with colleagues in the Treasury, and the Treasury would make those forecasts. Both then and now, it is HMRC that provides the underlying data and the first cut of the forecasts for discussion.”⁶⁴

70. The Committee stated in its report on proposals for a fiscal commission that “the Scottish Government should consider the option of inviting the SFC to produce the official macro-economic and fiscal forecasts for Scotland.”⁶⁵

71. The Government responded that it:

“believes that responsibility for carrying out economic and fiscal forecasts, including tax receipt forecasts, should lie with the Scottish Government and that primary accountability should be of Ministers to the Parliament. This is

⁵⁹ http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/20140424_Scottish_Government_response.pdf

⁶⁰ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/397079/Scotland_EnduringSettlement_acc.pdf paragraph 2.4.34

⁶¹ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 31](#)

⁶² [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 49](#)

⁶³ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 49](#)

⁶⁴ [Scottish Parliament Finance Committee, Official Report, 21 January 2015, Col 45](#)

⁶⁵ http://www.scottish.parliament.uk/S4_FinanceCommittee/Reports/fir-14-01w.pdf

consistent with the accountability of Ministers for economic and fiscal policy, to the limited extent that these are presently devolved. However the Government strongly believes that to provide maximum assurance to the Parliament, all forecasts should be subject to independent scrutiny by the SFC, with public reporting on that scrutiny. It believes that this approach will ensure robust and transparent forecasting and will assist the Parliament in holding the Scottish Government to account in as effective a way as possible.”⁶⁶

72. The Committee will take further evidence on whether the SFC or the Scottish Government should generate the economic forecasts as part of its inquiry on Scotland’s Fiscal Framework.

Borrowing

73. The Scotland Act 2012 provides Scottish Ministers with borrowing powers for three purposes from April 2015—

- up to 10% of the Capital DEL budget for capital spending for each year with a statutory limit of £2.2 billion;
- up to £200m annually and £500m in total to deal with deviations between forecast and actual revenues;
- an appropriate cash working balance to deal with temporary shortfalls between receipts and expenditure.

74. The Scottish Government is able to borrow up to £304m in 2015-16 and can do so from the National Loans Fund (NLF), from the banks on commercial terms or through issuing bonds. The Government has indicated that it plans to use these new powers in 2015-16. The modelling in the draft budget assumes that the money is borrowed from the NLF with repayments made over 25 years and charged at an interest rate of 5% from 2016-17 onwards.

75. Professor Heald argues in his written submission that “tax devolution (or the assignment of tax revenues) means that extensive borrowing powers are required in order to manage year-on-year fluctuations in revenues.”

76. Professor MacDonald argues that if the Scottish Government is being asked to take on more fiscal risk then it has to be given borrowing powers. His view is that borrowing should be done on the open market as this is “the only clean and effective way to bring market discipline.”⁶⁷ This is a view shared by Professor McLean who argues that “market discipline is the control that really works.”⁶⁸ However, Professor Kay cautioned that “realistically, the UK Treasury is not going to allow the Scottish Government what would be substantive borrowing powers.”⁶⁹

⁶⁶http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/20140424_Scottish_Government_response.pdf

⁶⁷ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 8](#)

⁶⁸ [Scottish Parliament Finance Committee, Official Report, 29 October 2014, Col 30](#)

⁶⁹ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 9](#)

77. Professor Muscatelli suggests that borrowing powers should be extended to “allow each devolved part of the UK to smooth out” asymmetric macroeconomic shocks which temporarily affect tax revenues. The extent of the borrowing powers may be limited by “a deficit ceiling, or there might be some sort of deficit rule that it would need to maintain over the cycle in a way that was consistent with the UK’s macroeconomic framework.”⁷⁰

78. Professor Trench stated in his written submission to the Committee in June that the devolved administrations should have the power to issue bonds. However, the UK Government could limit its liability from such borrowing by setting and publicising a ceiling of the maximum amount of devolved borrowing which it will indemnify.⁷¹

79. The Smith Commission recommends 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.” It should also have “sufficient borrowing powers to support capital investment, consistent with a sustainable overall UK fiscal framework.” Borrowing should also be subject to fiscal rules agreed by both Governments.

80. The UK Government Command paper states that meeting the Commission’s recommendations on borrowing will be dependent on a number of factors and will be subject to discussion between the two governments but “it is clear from international best practice that a set of fiscal rules and robust institutional arrangements will need to be in place to ensure that the overall UK public finances remain sustainable.”⁷²

Borrowing for capital expenditure

81. The Smith Commission recommended consideration of a prudential borrowing regime to support capital investment which should be consistent with a sustainable overall UK framework. The UK Government Command paper explains that the “Prudential Code was introduced to replace a system of credit approvals being sought by local authorities from central government, which in turn replaced an allocation of funds from central government for capital expenditure.” It goes on to state that the “application of a similar regime for the Scottish Parliament will be considered as set out in the Smith Commission Agreement.”⁷³

82. The Committee asked the CST to clarify whether the UK Government’s view is that the prudential borrowing regime which the Smith Commission recommends considering should replace rather than augment the capital grant. The CST responded that there “are positives and downsides to a prudential regime. Replacing the capital grant which we have at the moment could be difficult and I would have misgivings about that.”⁷⁴

⁷⁰ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 6](#)

⁷¹ http://www.scottish.parliament.uk/S4_PublicAuditCommittee/Meeting%20Papers/Papers_for_the_public.pdf

⁷² https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/397079/Scotland_EnduringSettlement_acc.pdf paragraph 2.4.28

⁷³ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/397079/Scotland_EnduringSettlement_acc.pdf paragraph 2.4.27

⁷⁴ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 16](#)

Borrowing for preventative spending

83. ICAS recommended in their submission to the Smith Commission that consideration is given to extending the borrowing powers of the Scottish Government and Scottish local authorities to “fund preventative spend initiatives within prescribed limits.”⁷⁵ This is justified on the basis that “preventative spending has a quality which is normally associated with capital expenditure in that its objective would be to deliver long-term benefits through reducing demand for public services and creating future savings.”⁷⁶

84. The Committee will take further evidence on what additional borrowing powers should be devolved and what fiscal rules should be applied to these powers.

85. The Committee would welcome the view of the Scottish Government on the proposal to allow borrowing to fund preventative spending within prescribed limits.

Scottish Cash Reserve

86. The UK Government has indicated that if receipts from the devolved taxes exceed forecasts then the priority should be to pay off any debt from previous years when receipts were lower than forecasts. If there is no outstanding debt then the additional revenues should be credited to a Scottish cash reserve “with the intention that they are used for any potential future deficits” and “will provide the flexibility to offset good and bad years.”⁷⁷

87. The Committee considered this issue as part of its scrutiny of Draft Budget 2015-16 and agreed with the Cabinet Secretary that the Scottish Government should have the flexibility to either spend the surplus tax receipts or put them in the cash reserve.

88. When questioned by the Committee on whether there should be flexibility, the CST responded that he would “be reluctant to go down that route” and it is important to build up the cash reserve to manage volatility in receipts. However, “it can of course be debated as part of the discussions on the financial framework.”⁷⁸

89. The Committee reiterates its view that the Scottish Government should have the flexibility to either spend any surplus tax receipts or put them in the cash reserve and will write to the CST.

Annual Tax on Enveloped Dwellings (ATED)

90. The Law Society of Scotland raised the issue of the appropriateness of retaining ATED in Scotland following the devolution of Stamp Duty. ATED was introduced in the UK in 2013 as a means of tackling SDLT avoidance. The Law

⁷⁵ http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/ICAS.pdf

⁷⁶ http://www.scottish.parliament.uk/S4_PublicAuditCommittee/General%20Documents/Additional_writ ten_evidence_to_the_Finance_Committee.pdf

⁷⁷ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69803/Scotland_Bill_Command_Paper.pdf page 39

⁷⁸ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 25](#)

Society of Scotland suggested that, given the Scottish Government has adopted a different approach to tax avoidance and that there is a provision within the LBBT legislation to address the issue, then ATED should not apply to properties in Scotland. While ATED currently only applies to properties with a value of £2m, this will reduce to £500,000 by April 2016.

91. The Committee has written to the Cabinet Secretary asking whether the Scottish Government has discussed with the UK Government whether ATED should continue to apply in Scotland. The Cabinet Secretary responded that we have “not considered it necessary to date to seek devolution of ATED or to seek disapplication of the tax in Scotland.” He points out that while the Scottish Government supports the intended purpose of ATED it “has thus far had very limited application in Scotland.”

92. The Committee asks whether the Scottish Government intends to continue monitoring the level of ATED being collected in Scotland and to inform the Committee if there is any significant change in the amount paid.

Conclusion

93. The Committee recognises that there is a need for confidentiality in inter-governmental relations and that much of this work takes place informally and between government officials. However, as recommended by the Smith Commission there is also a need for much stronger and more transparent parliamentary scrutiny. This should include as a minimum regular updates to the Parliament.

94. The Committee has published a call for evidence on the proposals for a fiscal framework for Scotland and intends to publish its report by the end of June. The Committee will then invite the Cabinet Secretary and HM Treasury to provide oral evidence in September. The Committee views this work as an initial contribution to the debate on the content of the fiscal framework and expects that both Parliaments are formally consulted on a draft framework.

ANNEXE A

Inquiry into the options for the further devolution of further financial powers to the Scottish Parliament - adviser briefing.

1. Following the Referendum in September 2014, the Smith Commission for further devolution of powers to the Scottish Parliament was formed. The Finance Committee agreed to contribute to the debate by examining the options for devolution of further financial powers to the Scottish Parliament and on 8 October 2014 called for written evidence to be submitted by 14 November 2014.¹ The Committee took further oral evidence from individuals or bodies², most of whom submitted written evidence prior to the relevant meeting.³ The Smith Commission gave its recommendations, which have cross-party support, on 27 November 2014⁴ and these formed the basis of a Command Paper, *Scotland in the UK: An enduring settlement*, published by the UK Government on 22 January 2015.⁵ This briefing summarises the evidence offered to the Finance Committee on the issues arising from the devolution of specific taxes whether or not recommended for devolution by the Smith Commission.

2. The Smith Report is structured as Heads of Agreement endorsed by the five political parties represented in Parliament and participating in the Commission. The recommendations on further devolution of taxes appear in Pillar 3 of the Heads of Agreement.⁶ The Commission proposes further devolution of power over the rates and bands of income tax on non-savings income, assignment of the first 10 percentage points of the standard rate of VAT, power to charge tax on air passengers leaving Scotland (replacing Air Passenger Duty) and the power to charge tax on commercial exploitation of aggregates (replacing Aggregates Levy). Taxes which it is proposed will remain fully reserved are National Insurance Contributions, Inheritance Tax, Capital Gains Tax, Corporation Tax and Oil & Gas Taxation, Fuel Duty and Excise Duties. The Heads of Agreement do not give reasons for these decisions. The Command Paper refers only to the taxes recommended for devolution and does so in Chapter 3 of the paper.⁷

Taxes proposed by the Smith Commission for devolution

Income Tax

3. The Scotland Act 1998 devolved a limited power to the Scottish Parliament over the basic rate of income tax, providing at Section 73 for a power to increase or decrease the basic rate percentage of income tax for Scottish Taxpayers by a number not exceeding 3 in respect of Scottish Taxpayers. This power did not extend to the savings or dividend rates applicable to Scottish Taxpayers and I will refer

¹ The call for evidence and written submissions can be found at

<http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/82234.aspx>

² Details of those who provided oral evidence are set out in Annexe C of the report.

³ The written evidence submitted in advance can be found in the papers for the relevant meeting and the oral evidence in the Official Report of each meeting. Both may be accessed at

<http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/85021.aspx>

⁴ [Report of the Smith Commission](https://www.smith-commission.scot/), <https://www.smith-commission.scot/>

⁵ <https://www.gov.uk/government/publications/scotland-in-the-united-kingdom-an-enduring-settlement>

⁶ [ibid.](#) pages 23 to 27.

⁷ [Scotland in the UK: An enduring settlement](#), pages 39 to 43.

hereafter to the income to which the dividend and savings rates do not apply as *non-savings income*. This power has never been exercised.

4. The Scotland Act 2012 devolved significantly greater powers over rates of income tax to the Scottish Parliament. Sections 25 & 26 provide that Parliament may set a Scottish Rate. The basic, higher and additional rates of tax for Scottish taxpayers are calculated by deducting 10 percentage points from the UK rates and adding the Scottish Rate set for the year. The legislation for this is already in place and the expected commencement date is 6 April 2016. This Scottish Rate of Income Tax (SRIT) is a significant extension of the existing power to vary the basic rate. It is not restricted to plus or minus 3 per cent and it applies to all three rates, not just the basic rate. More importantly, this is not something that the Scottish Parliament may opt into if it wishes. If the Scottish Parliament does not set the SRIT for any year, Scottish taxpayers will benefit from the full 10% deduction in their rates and the Scottish Government will receive no income tax.

5. This power to set the SRIT is constrained by the rates and bands set by the UK Parliament. The Scottish Parliament cannot change the number or breadth of the bands and the SRIT adjustment will apply uniformly to the rate set for such a band. The SRIT applies only to non-savings income.

6. The Smith proposal is to remove the constraints on rates and bands and to remove the slice of each band reserved for the UK Exchequer under the SRIT. However, the limitation to non-savings income remains. As a result the full amount of income tax paid by Scottish Taxpayers on non-savings income will accrue to the Scottish Government and the Scottish Parliament will set the bands and rates on such income. The rules defining income and its calculation, the introduction or amendment of reliefs, the personal allowance, the savings and dividend rates and the annual imposition of income tax will remain reserved to the UK Parliament. As a UK wide tax, although with Scottish variation in rates and bands, it will continue to be administered and collected by HMRC.⁸

7. The reservation of the personal allowance to the UK government while rates and thresholds are fully devolved seems a little odd. There is a good practical reason why reliefs in general are not devolved. The thresholds for the savings and dividend rates apply to total taxable income and devolving reliefs would have meant two different calculations of taxable income for Scottish taxpayers, one for savings and dividend income and another for non-savings income. This would give rise to a significant increase in the complexity of tax administration. As the personal allowance is in effect a zero-rate band, its devolution could be handled arithmetically with the other rates and bands. However, Danny Alexander MP, Chief Secretary to the Treasury (CST), explained that the personal allowance played a particular role in wider economic incentives in the labour market and that was the reason that it was reserved.⁹

8. Peter Kelly of the Poverty Alliance suggested that control over the personal allowance was fundamental to tackling poverty and should be devolved.¹⁰ The CST

⁸ [Scotland in the UK: An enduring settlement](#), page 23, paragraphs 75 to 79.

⁹ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 28](#)

¹⁰ [Scottish Parliament Finance Committee, Official Report, 17 December 2014, Col 4](#)

pointed out that, while the personal allowance could not be reduced by the Scottish Parliament, Parliament could set a zero rate band which would effectively increase the personal allowance.¹¹ The suggestion that reservation of the personal allowance is required to ensure that Scottish MPs can vote on the UK Budget and Finance Bill appears to miss the point that UK rates and thresholds for savings and dividend income, an integral part of the annual rate setting, continue to apply in Scotland.

9. Although the Smith proposal might seem to be simply a development of the SRIT, David Eiser, speaking before the publication of the Smith Report, saw such a development as significant:

*That would bring a very large revenue source fully into the control of the Scottish Parliament and it would give the Scottish Government the ability to address issues to do with inequality and redistribution. It would not represent the full panoply of tax powers, but relative to other countries around the world it would be a substantial level of tax devolution to a devolved government.*¹²

As one of the UK's larger revenue generators, the devolution of Income Tax on non-savings income will reduce the so-called fiscal imbalance as well as giving power to the Scottish Parliament to take an independent stance on inequality and redistribution. The fiscal imbalance is the difference between the proportion of national expenditure under the control of a sub-central government and the proportion of national revenue it controls. In international comparisons of sub-central governments, Scotland is currently an outlier in terms of the high proportion of expenditure and the low proportion of revenue under its control. The proposed devolution of non-savings income tax will shift the Scottish government towards the median at the decentralised end of the continuum.¹³ Indeed, together with the other tax and spending measures, the command Paper considers that, in controlling 60% of spending and retaining 40% of Scottish tax, Scotland will be one of the most powerful sub-central governments in the OECD, just behind the Canadian Provinces and Swiss Cantons.¹⁴

10. While the Scottish Government will have devolved power to set rates and bands, there will be constraints on the extent to which they are able to introduce differential rates from rUK. Professor Bell pointed out that factors of production, labour and capital, would ultimately move in response to differential taxes.¹⁵ The average person may be relatively unlikely to move elsewhere in the UK if his or her effective rate of tax is higher as a consequence of being a Scottish Taxpayer. But Professor David Heald pointed out that 22.55% of income tax in Scotland is paid by 42,000 individuals having incomes of £100,000 or above, who form 1.59% of taxpayers. These are a subset of the 217,000 taxpayers with income over £50,000

¹¹ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 28](#)

¹² [Scottish Parliament Finance Committee, Official Report, 8 October 2013, Col 10](#)

¹³ [Scotland's fiscal future in the UK, D. Bell and D. Eiser, Figure 2, Page 10,
http://esrcscotecon.files.wordpress.com/2014/09/scotlands-fiscal-future2.pdf](#) and [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 23](#), comments by Prof. MacDonald.

¹⁴ [Scotland in the UK: An enduring Settlement](#), paragraph 2.2.10.

¹⁵ [Scottish Parliament Finance Committee, Official Report, 8 October 2014, Col 10](#)

who together pay 44% of the income tax but represent only 8% of taxpayers.¹⁶ High earners are more likely to be able to find well-remunerated opportunities elsewhere in the UK and be willing to move. If higher rates of tax and bands on non-savings income of Scottish taxpayers are disproportionate to the higher rates of tax and bands on savings and dividend income set by the UK Government, there will also be increased pressure to convert non-savings income into dividend income. For owner managers, the self-employed and "contractors", this is already well-used planning to reduce NIC liabilities and the incentive will increase. There will also be pressure to arrange one's patterns of residence to avoid falling within the definition of a Scottish Taxpayer or simply to misinform HMRC about one's circumstances.¹⁷

11. Prof. Bell and D. Neiser caution that the potential movement of tax bases between different jurisdictions creates interdependence of tax rates and forms a real restraint on increasing rates of tax. This is particularly so with more mobile tax bases such as income tax. They cite a number of empirical studies of mobility, for example in Canada and Switzerland, but also caution that other factors may counteract mobility, such as better public services from higher taxation.¹⁸

12. The impact on Scottish finances of the devolution of Income Tax lies not only in the control of rates and bands but also how the block grant is adjusted in consequence of devolution. Professor Gallagher made the point that Income Tax's redistributive effects between income groups inevitably result in geographical redistribution, as income groups are not evenly distributed around the UK. By decoupling the setting of rates and bands for Scotland and the rest of the UK, with the governments potentially having different redistributive intentions, questions arise as to the consequential adjustments to the block grant. If, for example, the UK government were to decide to increase NHS spending and fund it by income tax increases, Scots might benefit through block grant consequentials but would not contribute to the funding.¹⁹ Conversely, if the UK government introduced charges for NHS services and reduced income tax as a result, the block grant would reduce but Scots would not see a corresponding reduction in income tax.²⁰ As Professor Gallagher commented, it is possible to design suitable block grant adjustments to avoid the risk of unintended advantages and disadvantages from tax and spend decisions made by one Government or the other and such issues will need to be addressed.²¹

13. The Command Paper identifies the issue, offering two worked examples of a decrease in 'rest of UK' income tax or alternatively an increase. Whether directly through an impact on reserved expenditure, or indirectly, through Barnett consequentials, the Scottish taxpayer could suffer public service cuts without a reduction in income tax or benefit from increased spending without a higher income

¹⁶ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 4](#) and [Scottish Parliament Finance Committee, Public Papers, 5 November 2014](#), Heald, paragraph 11.

¹⁷ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 4 & 19](#), comments by Prof. Heald.

¹⁸ [Scotland's fiscal future in the UK, D. Bell and D. Eiser](#), pages 12 and 13.

¹⁹ [Scottish Parliament Finance Committee, Official Report, 12 November 2014, Col 31 & 32](#)

²⁰ [ibid. columns 43 & 44](#),

²¹ [ibid. column 41 and Scottish Parliament Finance Committee, Public Papers, 12 November 2014, Gallagher, page 3](#).

tax cost.²² Under the Smith Commission's second 'no detriment' principle, *no detriment as a result of UK Government or Scottish Government policy decisions post-devolution*, a mechanism for adjustment between the governments must be developed.²³ The Chief Secretary to the Treasury suggested that the "two systems" would operate separately with revenues from Scottish income tax being spent in Scotland and revenues from income tax in England being spent in England. As income tax raised in England is less than expenditure in England on devolved matters, he considered that there was no substance to the concern that changes in the UK rates of income tax could unfairly disadvantage or benefit Scottish taxpayers.²⁴ The Cabinet Secretary for Finance, Constitution and Economy, considered that the concept of 'no detriment' was not well defined at the moment and that turning the principle into reality will take a number of years of negotiation and discussion.²⁵

14. In addition to the agreement of appropriate block grant adjustments, there will need to be consultation and cooperation between governments on income tax legislation. The Scottish Government publishes its draft Budget in the autumn including tax rates for the following year. If the Chancellor changes the tax base to which those rates apply in his Spring Budget, the Scottish Government's Budget will be impacted. Peter Kelly gave the example of a change in the personal allowance by the Chancellor impacting on the Scottish Government's rates and bands and called for the two Governments to work together in setting tax policy.²⁶ The CST suggested that changes to personal allowances, for example, will not be last minute announcements because HMRC needs significant lead time to prepare PAYE notices of coding. Rates and bands can be changed at short notice but these will not impact the Scottish Budget.²⁷ Similar issues will also arise, if less acutely, in budgeting for assigned VAT, as VAT rates have been changed at relatively short notice in the past.

15. There were differing views on the timing of the introduction of the Smith Commission's proposals for income tax. HMRC is working towards the introduction of SRIT on 6 April 2016. This involves the identification of Scottish taxpayers and the development of PAYE and other systems necessary to calculate and account for the tax due by them. Essentially, the additional requirements of the Smith proposals are further complexities in the calculation of the tax due. Isobel d'Inverno of the Law Society of Scotland suggested cutting out the "inflexible and strange proposal" of SRIT and implementing the Smith Commission proposal from 2016. On the contrary, Alexander Garden of the CIOT and Elspeth Orcharton of ICAS favoured implementing SRIT as planned and then moving to fuller devolution once it was clear that the identification of Scottish taxpayers and the new systems were satisfactory and that appropriate block grant adjustments were understood and agreed.²⁸

Value Added Tax

²² [Scotland in the UK: An enduring settlement](#), paragraph 2.4.14.

²³ [Report of the Smith Commission](#), paragraph 95(4)

²⁴ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 21](#)

²⁵ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 46](#)

²⁶ [Scottish Parliament Finance Committee, Official Report, 17 December 2014, Col 7 and 8](#)

²⁷ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 13, 15 and 29](#)

²⁸ [Scottish Parliament Finance Committee, Official Report, 10 December 2014, Col 32](#)

16. The Smith Commission proposal is that *the receipts raised in Scotland by the first 10 percentage points of the standard rate of Value Added Tax (VAT) will be assigned to the Scottish Government's Budget.*²⁹ To this, the Command Paper has added the first 2.5 percentage points of the reduced rate of VAT.³⁰ The standard rate is currently 20% and applies to supplies of goods and services that are not exempt, zero rated or taxed at the reduced rate of 5%. The difference between exemption and zero-rating is that no deduction is given for VAT incurred in the provision of exempt goods or services while a deduction is given in the case of zero-rated goods and services. Thus businesses providing zero-rated goods and services may find that their deductible input VAT exceeds their chargeable output VAT, giving rise to a refund from HMRC. Examples of exempt supplies are land, finance, health, education, postal services and others. Examples of zero-rated services are most foods, sanitation, books and newspapers, international services and others. The reduced rate of VAT applies to domestic fuel and power, energy saving materials, women's sanitary products, children's car seats and others. Certain small businesses and farmers may elect to account for VAT as a flat percentage of turnover at rates varying from 14.5% to 4% depending on the type of business. Professor Heald quoted a figure of 55% as the proportion of consumer expenditure subject to VAT.³¹ The VAT assigned under the Smith Commission proposal will not be a proportion of all VAT raised in Scotland but only that VAT raised through the application of the standard and reduced rates.

17. Instituting a value added tax and the removal of all other sales taxes is a condition of membership of the European Union. The EU sets down the structure of VAT and the range within which lower, standard and higher rates may be set. The zero-rate is essentially an "infra-low" rate below the normally permitted range. The maintenance of the zero-rate on a wide range of goods and services is a specific derogation agreed when the UK joined the EU. Those giving evidence to the Committee were in agreement that the EU constraints on VAT would not permit a sub-central government such as the Scottish Government to set rates of VAT different from those set by the central government. This constraint means that assignation rather than devolution is the only option for VAT and Professor Macdonald commenting on this (before publication of the Smith Report) proposed assigning 50% of VAT to the Scottish Parliament.³²

18. With assignation of a proportion of VAT, rather than devolution, the Scottish Government will have no control over the tax base or the rates. These will be decided by the UK Government. The other factor determining the amount of revenue received will be the level of economic activity. In the longer term, the Scottish Government may hope to exercise some positive influence on that. Professor Gallagher was concerned at the risk to the Scottish Government of revenue fluctuations that could not be managed through rate changes.³³ Pressed on the issue, he agreed that as part of a package the acceptance of a measure of risk was reasonable but that 10% was the maximum he would be comfortable with.³⁴

²⁹ [Report of the Smith Commission](#), paragraph 84.

³⁰ [Scotland in the UK: An enduring settlement](#), paragraph 3.3.1.

³¹ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 17](#)

³² [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 18](#)

³³ [Scottish Parliament Finance Committee, Official Report, 12 November 2014, Col 41](#)

³⁴ [Scottish Parliament Finance Committee, Official Report, 12 November 2014, Col 54](#)

Professor Muscatelli on the other hand considered that the only reason not to assign the whole of VAT would be to treat the unassigned portion as a form of equalisation fund and he gave Germany as an example.³⁵ The idea of equalisation is that if Scotland's economy does better than the rest of the UK, the rest of the UK would benefit through its proportion of the Scottish VAT yield. If on the other hand Scotland's economy does worse, the absolute amount of Scottish tax yield paid to the rest of the UK automatically reduces while centrally funded expenditure in Scotland benefits from the more buoyant VAT yield in the rest of the UK.

19. As mentioned by Professor McLean and others, with VAT as one of the major taxes, assignment of a proportion of it is significant in reducing the fiscal imbalance referred to in paragraph 8 above even although it does not give control.³⁶ In referring to this lack of control, Professor Muscatelli suggested that some form of consultation between the UK Government and the Scottish Government on VAT changes would be appropriate and he referred to other countries which assign VAT revenues and where sub-central authorities debate the tax take.³⁷ Professor Heald also raised the question of the block grant adjustment necessary when VAT revenues increase and whether this differs depending on whether the increase is a result of a UK change to the tax or not.³⁸

20. The representatives of the professional bodies raised an issue with the wording *receipts raised in Scotland* in the Report of Smith Commission.³⁹ The essence of a value added tax is that it is collected at each stage of the supply chain with a deduction given for the VAT charged earlier in the chain. As each business charges VAT to their customer and, in most circumstances, recovers the VAT they have been charged by their suppliers, paying over the difference to HMRC, the only people who bear the tax are the final consumers. The final consumers are the non-business purchasers of the goods and services or business purchasers who cannot recover input VAT as they make exempt supplies or are otherwise not registered for VAT. UK VAT registered businesses make one VAT return encompassing all UK business carried out by the person or entity. Against this background, Alexander Garden of the CIOT questioned whether it was currently possible to determine Scottish VAT receipts with an acceptable degree of accuracy.⁴⁰ Elspeth Orcharton of ICAS and Isobel d'Inverno of the Law Society of Scotland shared his concern and set out the alternative bases of a) determining VAT on consumption by final consumers in Scotland or b) on the basis of the VAT accounted for by businesses producing goods or services in Scotland. While a methodology note by HMRC points to the former basis, Orcharton and d'Inverno suggested that the latter basis captured Scotland's productive capacity. Either basis will require businesses to provide additional information on the location of customers or on the location of their business activities and an appropriate methodology needs to be worked out.⁴¹

³⁵ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 27](#)

³⁶ [Scottish Parliament Finance Committee, Official Report, 29 October 2014, Col 27](#)

³⁷ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 11, 12, 18 and 19](#)

³⁸ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 29](#)

³⁹ [Report of the Smith Commission](#), paragraph 84

⁴⁰ [Scottish Parliament Finance Committee, Official Report, 10 December 2014, Col 3 and](#)

⁴¹ <http://www.scottish.parliament.uk/parliamentarybusiness/28862.aspx?r=9690&mode=pdf>

⁴¹ [Scottish Parliament Finance Committee, Official Report, 10 December 2014, Col 4, 15, 16, 17, 25 and 26](#)

21. Questioned on the issue, the CST confirmed that the basis of determining the Scottish share of VAT had still to be determined and he was open to considering whether the assignment should be based on value added in Scotland rather than consumption in Scotland.⁴² The Cabinet Secretary for Finance, Constitution and Economy indicated that he was equally open to considering the matter and emphasised the importance that allocation must be on a verified basis.⁴³ Lindsey Fussell, HM Treasury, indicated that other countries, which assign VAT between tiers of government, offer a number of examples to build on.⁴⁴

Air Passenger Duty

22. Air Passenger Duty (APD) was one of the taxes identified as suitable for devolution by the Calman Commission but it was omitted from the Scotland Act 2012. Professor Muscatelli who advised the Calman Commission expressed surprise that it had not been included in the Scotland Act 2012 and was unaware of the reasons for its exclusion.⁴⁵ APD is an excise duty levied on aircraft operators on their carriage of passengers on flights from airports in the UK. The rate depends on the distance of the destination from London (determined as Bands A to D) and the class of travel. For luxury business jets, there are premium rates. From 1 November 2011, the rates for long haul flights from Northern Ireland were reduced to the Band A rate. From 1 April 2015, the Bands B to D will be merged into one long-haul band and the rates for luxury business jets are increased.

23. The Smith Commission proposes that the power to charge tax on air passengers leaving Scottish airports will be devolved to the Scottish Parliament which will be free to make its own arrangements for the design and collection of any replacement tax. This is full devolution including the power to define the tax base, the rules for taxing it and the rates and, indeed, whether to charge a tax at all.⁴⁶

24. There was little concern amongst those who gave evidence about practical difficulties. The representatives of the professional bodies, for example, considered that there were little technical or administrative difficulties in devolving the tax. Elspeth Orcharton of ICAS suggested that, if speed of implementation was desired, HMRC be asked to collect the new Scottish rate of APD while Revenue Scotland put the arrangements in place for a longer term transfer of administrative responsibility.⁴⁷

25. The only significant concern raised was the potential impact of tax competition and, in particular, the impact of lower Scottish APD rates on Newcastle Airport. Professor Heald, while noting that the reduced rate of APD for Northern Ireland had not created problems, was concerned that a significantly reduced Scottish Rate could have an effect on North of England airports, creating "internal political trouble in the UK". He also queried whether there might be EU issues of state aid.⁴⁸ Professor Gallagher, while broadly in favour of the devolution of APD, also

⁴² [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 30](#)

⁴³ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 48](#)

⁴⁴ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 30](#)

⁴⁵ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 12](#)

⁴⁶ [Report of the Smith Commission](#), paragraph 86.

⁴⁷ [Scottish Parliament Finance Committee, Official Report, 10 December 2014, Col 15 and 16](#)

⁴⁸ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 27 and 28](#)

expressed concerns about reduced Scottish rates harming the development of Newcastle Airport and speculated about the potential for varying UK rates on a regional basis to protect Newcastle's position.⁴⁹ Professor Muscatelli on the other hand considered that tax competition on APD could, on balance, have a beneficial effect by creating alternative hubs to the overstretched ones in the south-east of England.⁵⁰ The CST quoted a study which suggested that zero APD in Scotland would produce a 10% reduction in traffic in Newcastle and a 3% reduction in Manchester. He did not expect the Scottish Government would reduce tax on air passengers to zero so the economic impact in the north of England would be modest and simply a feature of the minor degree of tax competition that would be introduced by a lower Scottish rate.⁵¹

26. Garry Clark of the Scottish Chambers of Commerce considered that APD had a negative drag on the connectivity of Scottish Airports and this related to the devolved responsibility over tourism and enterprise. He advocated devolving and reducing or even eliminating APD.⁵² While Nicola Walker of the Scottish CBI agreed that APD was distortive and uncompetitive, she would rather these issues were dealt with at the UK level rather than create competition within the UK. While many Scottish members favoured devolution of APD, non-Scottish airports were most concerned at the prospect of devolution.⁵³

Aggregates Levy

27. Like APD, Aggregates Levy was identified by the Calman Commission as suitable for devolution. Legal issues prevented its devolution in the Scotland Act 2012. The Smith Commission propose that the power to charge tax on the commercial exploitation of aggregate be devolved to the Scottish Parliament once the legal issues have been resolved. The Scottish Government will have the power to design and collect any tax replacing Aggregates Levy.⁵⁴ Little mention was made of Aggregates Levy by those giving evidence but Professor Alan Trench counted it amongst taxes on land which he recommended for devolution.⁵⁵ Similarly, in their written evidence, the Law Society of Scotland refer to the immobile nature of the tax base resulting in little technical difficulty and its usefulness as an additional but limited fiscal lever.⁵⁶

Taxes proposed by the Smith Commission for reservation

National Insurance Contributions

⁴⁹ [Scottish Parliament Finance Committee, Official Report, 12 November 2014, Col 53](#)

⁵⁰ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 12](#)

⁵¹ [Scottish Parliament Finance Committee, Official Report, 28 January 2015, Col 27](#)

⁵² [Scottish Parliament Finance Committee, Official Report, 21 January 2015, Col 5](#)

⁵³ [Scottish Parliament Finance Committee, Official Report, 21 January 2015, Col 6](#)

⁵⁴ [Report of the Smith Commission](#), paragraph 89.

⁵⁵ [Public Papers, 19 November 2014, written evidence by Prof Trench, paragraph 9.](#)

⁵⁶ [Public Papers, 10 December 2014, submission from the Law Society, paragraph 18.](#)

28. The Smith Commission proposes that *all aspects of National Insurance Contributions (NIC) will remain reserved*. National Insurance comes in three distinct forms. It is levied on the earnings, benefits and profits of employees and self-employed persons (Class 1 primary, Class 2 and Class 4) and it is levied on employers on the wages, salaries and benefits provided to their employees (Class 1 secondary). Persons not liable may pay voluntary contributions in order to qualify for some benefits (Class 3). If by *tax* we mean a compulsory levy which brings no benefit to the payer other than enjoyment of general public goods, the NIC scheme is a hybrid, being voluntary for some (Class 3), qualifying individuals for benefits unavailable to non-payers (Class 1 primary and Classes 2 to 4) but effectively a payroll tax for employers (Class 1 secondary).

29. No NIC is levied on the earnings or profits of individuals once they reach the state pension age but employers must continue to pay for employees over the state pension age. There are lower earnings limits for employees and employers and a small-earnings exception limit for the self-employed below which no contributions are payable. Above the upper earnings limit, currently £41,865, employees cease to pay the main rate, currently 12%, on their earnings and pay only 2% on the excess. The self-employed pay a flat rate Class 2 contribution, currently £2.75 weekly, and a profit related contribution, currently 9%, up to the upper earnings limit and 2% on the excess. If viewed as a tax, this is regressive with the effective rate of NIC as a percentage of total earnings or profits falling as these increase above the upper earnings limit. The rate for employers applies to earnings without upper limit and is currently 13.8%. There are various exemptions and reliefs which may reduce NIC for some individuals or employers.

30. The evidence to the committee reflected the hybrid nature of NIC with the link between individuals' contributions and benefits, its relationship to income tax and the nature of employers NIC as a payroll tax all being offered as reasons to reserve or devolve NIC. As one of the experts giving evidence after the Smith Commission reported, Elspeth Ocharton of ICAS linked the reservation of NIC, along with employment law and the minimum wage, to the desire for a level playing field for employment purposes across the UK.⁵⁷

31. The link between NIC and entitlements to benefit and pension was cited by a number of experts as a reason, or a potential reason, for reserving NIC to the UK Government. Professor Gallagher considered that NIC on individuals was a gateway to the pension system and he wished to retain and strengthen the contributory principle. As such, he would not want NIC to be devolved. He noted, however, that the 2% above the upper earnings limit was a "substitute for income tax" on the employee and that the employer's contribution is a payroll tax which could be devolved.⁵⁸ While Professor Heald considered that economists were correct to regard NIC as a tax, public perception linked it to pension and benefits and politicians found that perception useful. For that reason and to avoid complicating future reform of the NIC system he was against devolving NIC.⁵⁹ Professor Muscatelli believes that there is now little linkage between NIC and the amount spent

⁵⁷ [Scottish Parliament Finance Committee, Official Report, 10 December 2014, Col 24](#)

⁵⁸ [Scottish Parliament Finance Committee, Official Report, 12 November 2014, Col 52 and 59](#)

⁵⁹ [Public Papers, 5 November 2014, Heald, para 14\(c\)](#); and [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 22 and 23](#)

on benefits and he suggested that NIC on individuals should be merged over time with Income Tax. As essentially integral to Income Tax, NIC is a candidate for devolution.⁶⁰ This view was also shared by Professor MacDonald, who considered that NIC was no longer geared to the welfare state but was an income tax. If the Income Tax base was to be devolved, so should NIC.⁶¹

32. In considering the linkage between NIC and Income Tax, it is important to note that there are two aspects to this linkage, the rates and base. Devolution of Income Tax under the Smith Commission proposal is devolution of the power to set rates and bands while legislating the tax base is reserved. If the key aspect of the linkage is that NIC rates are a supplementary tax on income, then devolution of the power to set NIC rates might logically follow devolution of the power to set income tax rates. On the other hand, the harmonisation of the NIC and Income Tax base, advocated by the Office of Tax Simplification⁶², would require the power over the NIC *earnings* base to remain reserved while the Income Tax base remains reserved. Both the CIOT and the Law Society referred to the opportunity that full devolution (rates and base) would give to rationalise or amalgamate Income Tax and NIC.⁶³

33. Employers NIC is not part of the contributory aspect of NIC and reliefs from it are already used as an economic lever to encourage employment of certain groups or assist and encourage certain businesses. Professor Muscatelli considered that devolution of employers NIC along with devolution of Corporation Tax would provide the Scottish Government with effective tools for economic development.⁶⁴ Peter Kelly of Poverty Action also recognised that devolution of NIC could be an important economic power.⁶⁵ Professor Trench considered that the case for devolution of employers NIC was weakened if there was no devolution of substantial welfare functions and cautioned that devolution would entail a significant overhaul of how the NI Fund works.⁶⁶ The STUC were concerned at competition dangers if employers NIC were devolved.⁶⁷

Capital taxes

34. The Smith Commission proposes that *all aspects of Inheritance Tax (IHT) and Capital Gains Tax (CGT) will remain reserved.*⁶⁸ Although bundled together as capital taxes, these two taxes are quite different. IHT is a tax on the transfer of wealth, taxing the estate of an individual when they die and also taxing certain lifetime gifts, principally those made within seven years of death. Capital Gains Tax on the other hand taxes the profit made on disposal of an asset. IHT taxes persons domiciled in the UK on all their assets and non-domiciled persons on their UK assets. CGT taxes UK residents on gains on disposal of assets wherever located

⁶⁰ [Scottish Parliament Finance Committee, Official Report, 12 November 2014, Col 17, 18 and 26.](#)

⁶¹ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 22](#)

⁶² *Review of Tax Reliefs*, Office of Tax Simplification, March 2011, http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/ots_review_tax_reliefs_final_report.pdf

⁶³ [Public Papers, 10 December 2014, CIOT, paragraph 1.3, Law Society, paragraph 13.](#)

⁶⁴ [Scottish Parliament Finance Committee, Official Report, 10 December 2014, Col 24 and 26](#)

⁶⁵ [Scottish Parliament Finance Committee, Official Report, 17 December 2014, Col 8](#)

⁶⁶ [Public Papers, 12 November 2014, Prof Alan Trench, paragraphs 9 and 20](#)

⁶⁷ [Public Papers, 17 December 2014, STUC, section 2, Specific Tax Powers](#)

⁶⁸ [Report of the Smith Commission](#), paragraph 81.

while non-residents, with certain exceptions, are not charged on the disposal of assets even if located in the UK.

35. As a tax based on residence, devolution of CGT could be based on the existing Income Tax definition of Scottish Taxpayer. Scottish domicile has the potential to be a much more difficult way to determine the tax base for devolved IHT. Domicile is typically acquired from one's father at the time of birth and only changes if a clear and settled intention to associate oneself with a different jurisdiction is demonstrated. Given mobility of population within the UK, there would be significant scope to argue that an individual had retained their domicile of origin or had changed it for a domicile of choice depending on which gave the most favourable tax position. There is a rule deeming long-term, non-domiciled residents of the UK to be domiciled in the UK for IHT purposes. This rule deems someone to be domiciled in the UK if resident in not less of 17 of the 20 years ending with the year in question. No doubt some such rule, linking domicile to settled residence, could be used to simplify the concept for devolved IHT.⁶⁹

36. Views on devolving these two taxes varied. The STUC and the Poverty Alliance saw devolution as essential to tackling inequities of land ownership and the redistribution of wealth⁷⁰ while Professor McLean, Professor Gallagher and ICAS saw these as small-yielding, complex taxes unlikely to be worth devolving.⁷¹

Inheritance Tax

37. For IHT the major concern expressed was erosion of the tax base as a result of choice of jurisdiction. As mentioned in paragraph 31 above, IHT could be modified so as to remove the ambivalence between domicile of origin and domicile of choice, replacing it with a settled residence test. This still leaves physical relocation as a tax planning opportunity. Professor Gallagher referred to Australian experience where people would choose to die in the lowest tax jurisdiction.⁷² On the other hand Professor MacDonald referred to experience in Switzerland where devolution of inheritance tax had not created a problem.⁷³ The Swiss experience is also mentioned by Bell and Eiser who quote research that found little evidence of mobility of wealthy retirees and cast doubt on allegations of tax competition between the cantons.⁷⁴ Professor Heald illustrated the risks of tax competition where an increase in IHT rates in Scotland might be matched by a reduction in IHT rates in Wales to attract wealthy taxpayers. Professor Kay agreed that devolution could create pressure for lower rates rather than resulting in raised rates to make the tax more progressive.⁷⁵

Capital Gains Tax

⁶⁹ [Public Papers, 10 December 2014, CIOT, Annex, section 9; ICAS, paragraph 5.34; and Law Society of Scotland, paragraphs 29 & 30](#)

⁷⁰ [Public Papers, 17 December 2014, STUC paragraph 1.6 and Poverty Alliance, paragraph 4.7.](#)

⁷¹ [Public Papers, 29 October 2014, Prof. Iain McLean; Scottish Parliament Finance Committee, Official Report, 12 November 2014, Col 61 and 62; and Public Papers, 10 December 2014, ICAS, paragraph 5.32](#)

⁷² [Scottish Parliament Finance Committee, Official Report, 12 November 2014, Col 34.](#)

⁷³ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 2](#)

⁷⁴ [Scotland's fiscal future in the UK, D. Bell and D. Eiser, page 13.](#)

⁷⁵ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 28](#)

38. With CGT, Professor McLean also suggested mobility was an issue, but mobility of the assets taxed rather than mobility of the taxpayer.⁷⁶ However, as currently legislated, CGT is based on the residence of the taxpayer and the CIOT suggested that this be maintained for a Scottish CGT to avoid overlap with UK CGT.⁷⁷ Professor Kay suggested that CGT was even more vulnerable to taking advantage of residence rules than IHT.⁷⁸ However, current UK CGT legislation contains anti-avoidance measures to prevent avoidance by means of short-term change of residence and similar measures could be continued in a devolved tax. The Law Society considered devolution of CGT possible but that avoidance opportunities would need to be countered.⁷⁹

39. The close connection between Income Tax and CGT was noted. Professor Heald warned of a risk to the Scottish tax base if Income Tax was devolved but CGT was not. Conversion of income into capital gains is a common tax planning device and such planning could move the tax base from higher rate Scottish income tax to lower UK CGT rates.⁸⁰ The link is stronger with savings and dividend income than with non-savings income and this led Professor Kay and ICAS to suggest that CGT should remain reserved while income tax on savings and dividend income is reserved.⁸¹ Professor Muscatelli noted that devolution of Income Tax would open the way to devolving CGT.⁸² The CIOT noted an opportunity for partial devolution with the Scottish Parliament setting a Scottish CGT rate analogous to the Scottish Rate of Income Tax and this could, indeed, be extended to mirror the Smith Commission proposal of full power over rates and bands.⁸³

40. The higher rate of CGT, 28%, applies to gains which, when added to the person's taxable income for the year, take them above the higher rate for the year. With power over rates and bands of Income Tax being devolved to the Scottish Parliament while CGT remains reserved, the Command Paper confirms that CGT rate of 28% will apply to a Scottish taxpayer where, when added to their taxable income, the gain lies above the UK income tax higher rate band.⁸⁴

Corporate taxes

41. The Smith Commission proposes that *all aspects of Corporation Tax (CT) and all aspects of the taxation of oil and gas receipts will remain reserved.*⁸⁵ While some

⁷⁶ [Scottish Parliament Finance Committee, Official Report, 29 October 2014, Col 28](#)

⁷⁷ [Public Papers, 10 December 2014, CIOT, section 2.](#)

⁷⁸ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 2](#)

⁷⁹ [Public Papers, 10 December 2014, Law Society of Scotland, paragraph 31.](#)

⁸⁰ [Public Papers, 5 November 2014, Prof. Heald, paragraph 12](#) and [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 2](#)

⁸¹ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 2](#); and [Public Papers, 10 December 2014, ICAS, paragraph 5.22.](#)

⁸² [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 7](#)

⁸³ [Public Papers, 10 December 2014, CIOT, section 2.](#)

⁸⁴ [Scotland in the UK: An enduring settlement](#), paragraph 3.2.4.

⁸⁵ [Report of the Smith Commission](#), paragraphs 82 and 83.

Oil and Gas receipts are in the form of Petroleum Revenue Tax, the bulk falls within CT as tax on the profits of "ring fenced" trades or as supplementary charge on such profits. However, the ring fence rules essentially carve out a separate tax regime and the debate, as well as the figures provided in GERS statistics, lump the various receipts relating to Oil and Gas together and treat them separately from CT. I will summarise the evidence on CT and the evidence on Oil and Gas taxation separately.

Corporation Tax

42. The majority of those giving evidence were against, or had major reservations, about the devolution of Corporation Tax. Maintaining a level playing field or avoiding tax competition within the UK was one motive. The STUC supported, not just one UK rate, but harmonisation of CT throughout the EU.⁸⁶ Nicola Walker of the CBI said that their members valued the single rate of CT in the UK and that it was good also for inward investment.⁸⁷ Not everyone saw tax competition as negative. Tax competition is a fact internationally and within some federal states such as the US. Professor Bell pointed out that differences between US states in their rates of corporate taxes did not give rise to serious competition issues. Other barriers to relocation predominated.⁸⁸ David Eiser's view was that the similarity of the UK nations made relocation of business simpler than in the US and consequently differing CT rates would have greater effect.⁸⁹ Professor MacDonald commented that competition between Canadian Provinces works well but the asymmetry between Scotland and the rest of the UK, together with an already low CT rate of 20%, would militate against it doing so here.⁹⁰

43. There was considerable concern at the scope for tax avoidance and mention made of media stories regarding multi-national groups paying little tax in the UK compared to their economic activity here. Devolution would open the way to similar avoidance within the UK.⁹¹ Professor Heald referred to the current OECD drive to tighten the rules under the Base Erosion and Profit Shifting (BEPS) project but believed differing tax rates within the UK would remain vulnerable to profit shifting.⁹² There is scope for mitigating this by using alternative methods of allocating profits to jurisdictions as mentioned below in paragraphs 39 and 40.

44. Another common concern was the difficulty of determining the Scottish profits of a company operating both in Scotland and also elsewhere in the UK. Corporation tax is charged on the profits of a company resident in the UK or on the permanent establishment in the UK of a non-resident company with double tax rules enshrined in legislation and treaties to mitigate double taxation where two countries tax the same profit. If the same methodology were to be applied in determining Scottish profits, it would require companies operating in Scotland and elsewhere in the UK to

⁸⁶ [Public Papers, 17 December 2014, STUC](#)

⁸⁷ Meeting 21 January 2015, personal notes (OR not published at time of writing.)

⁸⁸ [Scottish Parliament Finance Committee, Official Report, 8 October 2014, Col 5](#)

⁸⁹ [Scottish Parliament Finance Committee, Official Report, 8 October 2014, Col 5](#)

⁹⁰ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 21](#)

⁹¹ [Scottish Parliament Finance Committee, Official Report, 29 October 2014, Col 26 and 27](#), Prof McLean; and [Scottish Parliament Finance Committee, Official Report, 12 November 2014, Col 52 and 53, Prof. Gallagher.](#)

⁹² [Scottish Parliament Finance Committee, Official Report, 5 November 2014](#), Prof. Heald, paragraph 14(a).

keep separate accounts and apply transfer-pricing principles between the parts of the enterprise.⁹³ Alexander Garden of the CIOT and others expressed concern that large numbers of business, not previously exposed to the international allocation of profits, would have a significant increased burden thrust on them.⁹⁴ There was recognition by ICAS and others that an alternative method of allocating profit to Scotland could be devised.⁹⁵

45. Professor Muscatelli, who saw potential in devolving CT for economic development, suggested one alternative basis for allocating CT profit. He referred to the Holtham Commission (2010) and their proposal that profit allocation be linked to factors such as level of employment. He saw this, or alternatively capping the level of rate variation, as a way to avoid harmful competition and discourage "brass plate" relocation.⁹⁶ Interestingly, the Corporation Tax (Northern Ireland) Bill⁹⁷ introduced in the House of Commons on 8 January 2015 partially adopts this approach. The whole profit of small and medium enterprises (SMEs - EU definition) will be taxed at the Northern Ireland Rate if 75% of staff time and 75% of staff costs relate to work in Northern Ireland. Large enterprises will have their profits apportioned using a slightly modified version of the international rules.⁹⁸

46. The potential that differential rates of CT might be challenged under the EU state aid rules was mentioned by Professor Trench and others,⁹⁹ while the Law Society of Scotland referred to the complications that could arise with full devolution in adapting the UK's tax treaty network and obligations.¹⁰⁰

47. As well as full devolution of CT, including the power to determine the tax base, there could be devolution of power to set rates and bands only, similar to the Smith Commission's proposal for Income Tax.¹⁰¹ This would still require a method of determining Scottish corporate profits as is done for Northern Ireland in the new Bill mentioned in paragraph 40 above. Even without that, the CIOT pointed out that there is precedent for capital allowance rates and some other reliefs to vary by region or location, so such a power could be delegated to the Scottish Parliament or exercised by mutual agreement.¹⁰² Assignment of revenues rather than devolution was mentioned both positively and negatively as an alternative to devolution of CT. Professor Muscatelli considered that assignment provided no economic levers,¹⁰³ while Professor MacDonald considered that assignment, but not devolution, of CT would be acceptable.¹⁰⁴ On assignment of CT, the CIOT commented on the difficulty

⁹³ [Public Papers, 10 December 2014, CIOT, paragraphs 3.3 and 5.1; and ICAS paragraph 5.24](#)

⁹⁴ [Scottish Parliament Finance Committee, Official Report, 10 December 2014, Col 13](#)

⁹⁵ [Public Papers, 10 December 2014, ICAS, paragraph 5.26.](#)

⁹⁶ [Public Papers, 19 November 2014, Prof. Muscatelli; Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 4 and 5](#)

⁹⁷ Bill 149, www.publications.parliament.uk/pa/bills/cbill/2014-2015/.../15149.pdf

⁹⁸ HMRC, *Corporation Tax: devolution of rate-setting power to Northern Ireland*, page 1 <https://www.gov.uk/government/publications/corporation-tax-devolution-of-rate-setting-power-to-northern-ireland>

⁹⁹ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 48](#)

¹⁰⁰ [Public Papers, 10 December 2014, Law Society of Scotland, paragraph 26.](#)

¹⁰¹ [Ibid. ICAS paragraph 5.23.](#)

¹⁰² [Ibid. CIOT, paragraph 5.5.](#)

¹⁰³ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 23 and 24](#)

¹⁰⁴ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 21](#)

of ascertaining to an acceptable standard the revenue attributable to Scotland,¹⁰⁵ while ICAS suggested that assignment of CT based on a measure of Scottish economic activity is a possibility.¹⁰⁶

Oil and Gas Taxation

48. The views expressed to the Committee on devolution of Oil and Gas Taxation largely turned on the relative importance given to the immobility of the source and the volatility of revenues. Professor McLean gave greater weight to Adam's Smith's preference for taxing "ground rents" and suggested that Oil and Gas taxation is a prime candidate for devolution.¹⁰⁷ If the people of Scotland want devolution of taxes, which they do, they simply must learn to live with the volatility.¹⁰⁸ Professor Heald on the other hand viewed natural resource rents as part of the pool of UK resources and gave that and the volatility of revenues as a reason not to devolve.¹⁰⁹ Professor MacDonald considered that non-devolution and distribution through the block grant was an effective cushion for Scotland from the volatility of oil revenues. While it would be in principle possible to replace this cushion with an oil fund, it would be very difficult to achieve in the near term.¹¹⁰ Professor Gallagher suggested that the key choice was not determined by conflicting economic theories but by the fact that tying Scottish public spending to an inevitably declining source meant a real cut in public expenditure.¹¹¹ Declining oil revenues are better managed at UK level.¹¹² Professor Trench considered the larger size of the UK and its ability to collect larger amounts from a range of smaller taxes made for better management of volatile oil and gas revenues.¹¹³

49. Professor Muscatelli considered that the sector could still be hugely important for Scotland and issues around future development require the use of clear economic levers.¹¹⁴ However, he considered it critical that, if there is devolution, then it is complete devolution. The industry needs stability and certainty and that would not be provided if there were divided responsibilities.¹¹⁵ The long-term decline of the source is not so much a macroeconomic shock as an economic development trend and requires management by growing other aspects of the economy.¹¹⁶ Shorter-term fluctuations can be managed by evaluating the borrowing powers necessary to offset sudden changes in revenue.¹¹⁷

50. The CIOT make a practical point regarding tax relief for future abandonment cost. Companies with installations on the Continental Shelf are currently entitled to relief for the costs of removing them when production ceases. If Oil and Gas taxation is devolved, the Governments would need to agree on the future funding of

¹⁰⁵ [Public Papers 10 December 2014, CIOT, paragraph 3.6.](#)

¹⁰⁶ [Ibid. ICAS, paragraph 5.29.](#)

¹⁰⁷ [Scottish Parliament Finance Committee, Official Report, 29 October 2014, Col 26 and 27](#)

¹⁰⁸ [Scottish Parliament Finance Committee, Official Report, 29 October 2014, Col 30.](#)

¹⁰⁹ [Public Papers, 5 November 2014, Heald, paragraph 14\(d\).](#)

¹¹⁰ [Scottish Parliament Finance Committee, Official Report, 5 November 2014, Col 25](#)

¹¹¹ [Scottish Parliament Finance Committee, Official Report, 12 November 2014, Col 47](#)

¹¹² [Scottish Parliament Finance Committee, Official Report, 12 November 2014, Col 48](#)

¹¹³ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 52 and 53.](#)

¹¹⁴ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 20](#)

¹¹⁵ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 11](#)

¹¹⁶ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 23](#)

¹¹⁷ [Scottish Parliament Finance Committee, Official Report, 19 November 2014, Col 26](#)

the relief and the companies will need assurance that they will get the relief when the time comes.¹¹⁸

Fuel Duty and Excise Duties

51. The Smith Commission proposes that *all aspects of Fuel Duty and Excise Duties will remain reserved*.¹¹⁹ Excise Duties, which include Fuel Duty, are subject to EU directives which prescribe upper and lower limits for rates. Some states have received derogations from these and it is also possible to add to the range of goods, with some states imposing duty on coffee and chocolate. The EU allows the imposition of "parafiscal taxes" on health or other legitimate grounds which could be applied while retaining a unified excise duty rate.¹²⁰

52. Subject to EU legal restrictions and to the provisions of the Treaty of Union,¹²¹ most experts agreed that devolution of excise duties, as a tax on consumption, was possible. The principle concerns were around cross-border shopping and illegal smuggling with problems at the Channel and the land border with the Irish Republic being cited.¹²² Professor Macdonald was concerned that devolution of Excise Duties in a single market might create distortions which could outweigh the benefits to health policy, for example, of an increase in alcohol duty. Although excise duties are, in a sense, a consumption tax they are levied at the production stage which, he considered, would make the problem greater.¹²³ He did however suggest that excise duties could be assigned,¹²⁴ a view shared with the STUC and Poverty Alliance who wished to assign 50%.¹²⁵

Gavin McEwen
11 February 2015

¹¹⁸ [Public Papers, 10 December 2014, CIOT, paragraphs 3.3 and 6.3](#)

¹¹⁹ [Report of the Smith Commission](#), paragraph 92.

¹²⁰ [Public Papers, 10 December 2014, CIOT, section 7.](#)

¹²¹ [Public Papers, 19 November, Trench, paragraph 9](#); and [Official Report, 19 November 2014, column 48, Prof Trench.](#)

¹²² [Scottish Parliament Finance Committee, Official Report, 29 October 2014, Col 34](#), Prof. McLean; and [Public Papers, 10 December 2014, CIOT, section 7](#), and Law Society, paragraph 36.

¹²³ [Public Papers, 5 November 2014, MacDonald, section 3.](#)

¹²⁴ [Ibid.](#)

¹²⁵ [Public Papers, 17 December 2014, STUC, paragraph 2.5](#); and [Scottish Parliament, Finance Committee, Official Report, 17 December 2014, column 13](#), Peter Kelly.

ANNEXE B: PRINCIPLES AGREED THROUGH THE JOINT EXCHEQUER COMMITTEE IN SEPTEMBER 2011 FOR THE ADJUSTMENT OF THE BLOCK GRANT

Design

1. Apply the overarching objective of fairness to both the UK and Scottish Governments by:
 - a) minimising the risk of gains/losses from funding transfers on both the UK and Scottish Governments;
 - b) ensuring that the mechanism is not, when implemented, designed to gain advantage in one set of fiscal circumstances or another;
 - c) considering the effects of a shared tax base (including issues related to policy spillover and tax avoidance).
2. Ensure the mechanism delivers on the Scotland Bill's aims to increase financial accountability, giving the Scottish Parliament a direct financial stake in Scotland's economic success;
3. Ensure the mechanism is consistent with Azores criteria and State Aid principles;
4. Ensure the sustainability of the system to adapt to future decisions on tax devolution;

Implementation

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

Operation

6. Ensure that the necessary information and data is shared on a timely and accurate basis to allow both the UK and Scottish Government to plan ahead;
7. Ensure the mechanism delivers value for money by designing a model that is relatively simple to implement and operate and incurs minimal administrative cost;

Review

8. Apply principles of transparency; and
9. Review to ensure that the system remains fair and 'fit for purpose'.

ANNEXE C: ORAL AND WRITTEN EVIDENCE

26th Meeting, 2014 (Session 4) Wednesday 29 October 2014

ORAL EVIDENCE

Professor Iain McLean, Professor of Politics, University of Oxford.

27th Meeting, 2014 (Session 4) Wednesday 5 November 2014

ORAL EVIDENCE

Professor David Heald, Professor of Accountancy, University of Aberdeen; Professor John Kay, Professor of Economics, London School of Economics; Professor Ronald MacDonald, Professor of Political Economy, University of Glasgow.

28th Meeting, 2014 (Session 4) Wednesday 12 November 2014

ORAL EVIDENCE

Professor Jim Gallagher, Member of Nuffield College Oxford, and Visiting Professor Glasgow University.

29th Meeting, 2014 (Session 4) Wednesday 19 November 2014

ORAL EVIDENCE

Professor Anton Muscatelli, Principal and Vice-Chancellor, University of Glasgow; Professor Alan Trench; Ben Thomson, Campaign for Scottish Home Rule.

32nd Meeting, 2014 (Session 4) Wednesday 10 December 2014

ORAL EVIDENCE

Elsbeth Orcharton, Director, Corporate and International Taxation, The Institute of Chartered Accountants of Scotland; Isobel d'Inverno, Convener of the Tax Law Committee, Law Society of Scotland; Alexander Garden, Chair, Chartered Institute of Taxation Scotland Hub.

33rd Meeting, 2014 (Session 4) Wednesday 17 December 2014

ORAL EVIDENCE

Peter Kelly, Director, Poverty Alliance; Dave Moxham, Deputy General Secretary, Scottish Trades Union Congress.

3rd Meeting, 2015 (Session 4) Wednesday 21 January 2015

ORAL EVIDENCE

Colin Borland, Head of External Affairs, FSB Scotland; Garry Clark, Head of Policy and Research, Scottish Chambers of Commerce; Nicola Walker, Director of Devolution, Confederation of British Industry; Edward Troup, Second Permanent Secretary, and Sarah Walker, Deputy Director and Head of Devolution Team, HM Revenue and Customs.

4th Meeting, 2015 (Session 4) Wednesday 28 January 2015

ORAL EVIDENCE

Rt Hon Danny Alexander MP, Chief Secretary to the Treasury, and Lindsey Fussell, Director Public Services, HM Treasury, UK Government.

John Swinney, Cabinet Secretary for Finance, Constitution and Economy, and Sean Neil, Acting Deputy Director of Finance, Scottish Government.

WRITTEN EVIDENCE

- [Professor Alan Trench](#)
- [Professor Anton Muscatelli](#)
- [Ben Thompson](#)
- [CIOT \(63KB pdf\)](#)
- [CIPFA \(277KB pdf\)](#)
- [Confederation of British Industry \(51KB pdf\)](#)
- [COSLA \(24KB pdf\)](#)
- [Damian Forster D&N Forster Property \(13KB pdf\)](#)
- [Professor David Heald](#)
- [Dr JR Cuthbert and Mrs M Cuthbert \(148Kb pdf\)](#)
- [Iain McLean](#)
- [ICAEW \(21KB pdf\)](#)
- [ICAS \(206KB pdf\)](#)
- [Institute and Faculty of Actuaries \(370KB pdf\)](#)
- [Institute for Government](#)
- [Professor John Kay](#)
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- [LITRG \(118KB pdf\)](#)
- [NFU Scotland \(24KB pdf\)](#)
- [NHS Health Scotland \(54KB pdf\)](#)
- [NUS Scotland \(12KB pdf\)](#)
- [Peter Hickman \(19KB pdf\)](#)
- [PwC \(123KB pdf\)](#)
- [Professor Ronald MacDonald](#)
- [SCDI \(361KB pdf\)](#)
- [Scottish Chamber of Commerce \(83KB pdf\)](#)
- [Scottish Retail Consortium \(69KB pdf\)](#)
- [SCVO \(39KB pdf\)](#)
- [The Law Society of Scotland \(70KB pdf\)](#)
- [Transform Scotland \(19KB pdf\)](#)

SUPPLEMENTARY WRITTEN EVIDENCE

- [ICAS \(88KB pdf\)](#)

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