Scotland’s Fiscal Framework
Evidence from ICAS
17 April 2015
About ICAS

1. The Institute of Chartered Accountants of Scotland (“ICAS”) is the first professional body of accountants. We represent around 20,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK and in almost 100 countries around the world. Nearly two thirds of our members work in business, whilst a third work in accountancy practices. ICAS members play leading roles in around 80% of FTSE 100 companies.

2. ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. Evidence provided by ICAS aims to inform in a positive and constructive manner. ICAS is apolitical and will not take a stand for or against a particular political position. From a public interest perspective, our role is to share insights from ICAS members in the many complex issues and decisions involved in tax and financial system design, and to point out operational practicalities. Our representatives also contribute based on the collective experience of decades of work which ICAS members and staff have undertaken with both the UK and Scottish Parliaments and tax authorities on the shared agenda of a better outcome for all stakeholders.

General comments

3. ICAS welcomes the opportunity to give evidence to the Finance Committee regarding Scotland’s fiscal framework as proposed in chapter 2 of the paper ‘Scotland in the United Kingdom: An enduring settlement’ issued by HM Government in January 2015.

4. Our evidence is restricted to ICAS areas of specific expertise, which are tax and borrowing for preventative spending.

5. The draft tax clauses in the paper ‘Scotland in the UK: an enduring settlement’ will, in general terms, achieve their objectives of devolving certain powers and taxes. However, questions and issues arise about the related non-statutory material and processes, such as how the consequential block grant adjustments will be calculated. It is still not yet clear how “no detriment” will be interpreted but useful discussion is taking place on potentially differing expectations. The resolution of these points will have an impact on whether the devolved taxes achieve their aims of greater accountability between the Scottish parliamentarians and their electorate.

6. Part of the fiscal framework is the ability to raise revenues and the overall result of the Scotland Act 2012 and the Smith Commission’s recommendations on devolving taxes further will be:

- Three, or more, implementation dates for new tax powers in Scotland:
  - 1 April 2015 for Land and Buildings Transaction Tax and for Scottish Landfill Tax
  - 6 April 2016 for Scottish Rate of Income Tax
  - A date(s) in the future for the Smith recommendations to extend the income tax rates and bands; to devolve Air Passenger Duty and Aggregates Levy; and the assignment of VAT, and

- Three different levels and/or types of devolution:
  - Full devolution - Land and Buildings Transaction Tax, Scottish Landfill Tax, Aggregates Levy and Air Passenger Duty
  - Partial devolution - Income Tax rates and bands
  - Assignment – a proportion of VAT receipts

7. In public usage the phrases “Scottish taxes” or “devolved taxes” tend to encompass different types of devolution and varying amounts of responsibilities, and can lack precision. The nature of the powers over income tax are fundamentally different from those devolved by, for example, Land and Buildings Transaction Tax. There is great scope for confusion in public understanding; hence fairness and transparency may take time in being achieved for the public at large.
8. Future tax policy will both support, and be determined by, decisions on elements of the fiscal framework, at both the UK and Scottish levels. Consideration of any fiscal framework, therefore, should allow for a number of influences. First, there needs to be recognition that the different components in the UK tax system are intricately intertwined; income tax and capital gains tax provisions for example are often designed to be complementary. Secondly, tax outcomes are subject to the behavioural response of taxpayers. As a result, the impact of tax changes, and the amounts to be collected, can be difficult to assess in isolation, and require sophisticated and informed scenario analysis.

9. Different structures and tax competition may affect tax rates, as has already happened for example when Stamp Duty Land Tax (SDLT) structure and rates were changed in December 2014 and Land and Buildings Transactions Tax (LBTT) rates subsequently changed. This resulted in:
   - Less tax being raised at a UK level
   - A lower block grant adjustment
   - Greater differences in tax outcomes; leading to a debate on whether a particular outcome is tax competition or might be a part of the ‘no detriment’ analysis
   - Behavioural impacts by taxpayers, for example, a lower level of sales in the upper end of the property market and possibly more activity at the lower end of the property market.

10. Care will need to be taken so that plans in the Scottish Government are developed to deliver the financial analysis necessary to support policy decisions. The Government needs to work out how much tax it will really raise, at the different rates of tax, in order to support its decision making. Investment in data gathering and financial modelling mechanisms will be required.

11. With three types of tax devolution proposed, as described at point 6 above, it should be noted that there are fundamental differences between them in both political and administrative responsibilities. Partially devolved income tax powers will potentially result in greatest complications in the fiscal framework. Political responsibility will be split between the UK and Scottish Parliaments. The UK Parliament will be responsible for the tax base (what is considered to be income, and how it is measured) and the Scottish Parliament is responsible for the rates and the bands (how much is assessed for collection). Administrative responsibility will remain with HMRC, for which the Scottish Government will pay any additional costs of collection. Joint responsibilities may make the detail and financial costs of ‘no detriment’ more difficult to identify clearly.

12. When some elements are devolved such as income tax on non-savings income, this may open the way to greater complexity, wider differentials and increased attempts at planning to avoid increased tax costs. For example, if income tax rates in Scotland were to increase, then those in family businesses may reduce their salary and increase their dividend payments. This would have two consequences, being (i) a reduction in the overall tax payable, and (ii) a swing from income tax to dividends would mean a decrease in Scottish income tax revenue and an increase in tax on dividends in the rest of the UK receipts. There could also be a question of whether this would impact on ‘no detriment’ calculations.

13. VAT remains the responsibility of the EU (in terms of defining the tax base), and the UK Parliament (in setting the tax rates), with administration and collection by HMRC. How accountability to the Scottish Parliament is arrived at through assignment has yet to be decided, and is not determined or directed in the draft tax clauses. Considerable analytical and statistical work will be required if there is to be an amount that can be identified which truly reflects the VAT attributable to Scotland and will in future reflect any changes in the Scottish economy.

14. Questions include how the VAT statistics are to be arrived at for Scotland; and will this be based on production and value added basis, or on a consumption basis? To illustrate the potential differences consider the following possibilities:
a. Production based – products and services have output tax charged at each stage when value is added in the economic chain, and credit is given for this as input tax, until the sale is made to the final consumer. Within the UK, where there is considerable trade between Scotland and the rest of the UK it may be difficult to pinpoint which elements of output VAT, less which elements of input VAT, might constitute ‘Scottish VAT’, or

b. Consumption based – the VAT paid when goods and services are sold to a final consumer in Scotland could form a measure but it would not necessarily reflect the productivity or the success of the Scottish economy: much of the underlying work in the goods and services might have been done outwith Scotland or vice versa with Scottish products being sold outside Scotland.

15. VAT is collected by traders; however, the location of a trader may not reflect where the trade is conducted. For example, a high street chain will probably have one office where the VAT return is collated for all shops across the UK. Also, many larger groups may have a single group registration for VAT. There is no clear, obvious basis that offers fairness and transparency; and that can take account of economic activity and policy in Scotland. Any decision on the calculation of the VAT assignment then also needs to be informed how the “no detriment” principle will be applied to VAT assignments.

16. It will be important to determine what independent oversight might be given to the operation and maintenance of the agreements and output of the “no detriment” principle. This might be by the Office for Budget Responsibility, the Scottish Fiscal Commission, or both, or if wider tax devolution within the UK is proposed, possibly another entity.
Specific questions

1. What needs to be included within a revised funding framework for Scotland and how do we ensure that it is fair, transparent, effective and mechanical rather than requiring regular negotiations?

Taxes, and the revenue that they raise, will be one element of the revised funding framework and if the framework is to be fair, transparent and effective there needs to be a clear understanding of the component parts. The various 'Scottish taxes' are different, with some fully devolved, income tax partially devolved, and VAT assigned. However, as discussed above, this means that their nature and impact on the Barnett adjustments may differ.

Ensuring fairness and effective mechanical measures involves significant analytical and statistical input. Fairness may require more detailed calibration of different balancing elements in the Barnett formula adjustments, but the greater the analytical detail and complexity of arithmetical tax adjustments the more this is likely to reduce transparency. A balance needs to be found between these conflicting aims.

2. What fiscal rules should be applied in order to ensure fiscal responsibility and debt sustainability?

We have no comments in relation to this question.

3. What mechanisms are required to ensure the transparency and effective scrutiny of how the block grant is calculated including the operation of the Barnett formula?

We question whether there is currently transparency or understanding of the principles of the block grant allocation or the Barnett formula. Better information on this starting point will assist understanding of the adjustments to reflect tax devolution.

The mechanisms that are required will need to find a balance between a broad-based approach and a detailed approach. With a broad, principles-based approach it should be easier to conclude that the result should give the desired outcome. However given the starting point is at a detailed level, a methodology of working through specific examples and illustrations will be required to ensure proper alignment with the principles based proposals aimed at ensuring the desired ‘no detriment’ outcome. To have effective mechanisms will require analysis, relevant statistics, and resourcing to undertake the work.

4. What mechanisms are required to ensure the transparency and effective scrutiny of adjustments to the block grant to reflect the tax revenues foregone by the UK Government?

Matters to be considered are discussed at 3 and in the general comments above.

5. What mechanisms are required to ensure the effective working of the “no detriment” principle?

Before deciding upon the mechanisms, there needs to be agreement as to what might constitute “no detriment”. In plenty discussions on this topic, there has been a lack of consensus of what might be detrimental and therefore should be taken into account in rebalancing adjustments, and what might simply be tax competition and might be part of the rationale for devolving a particular tax power.

Because taxes are used to deliver a wide ranging number of policies, such as to raise money, and to encourage certain behaviours, for example recycling with Scottish Landfill Tax, it may be difficult to disentangle the “no detriment” element that one would expect to analyse and calculate purely in monetary, tax raising terms.

This can be further affected by the contradictory policy aims of using potential tax savings, for example in UK taxes offering ISAs or capital allowances to encourage certain
behaviours, but which can then be castigated as tax avoidance. Isolating what constitutes “no detriment” from such a range of policy aims will require considerable care. Once such points are addressed and agreed, it may then be easier to identify the appropriate mechanisms with which to calculate and give effect to the ‘no detriment’ principle. Agreeing the appropriate adjustments at the outset will be one task, however the subsequent adjustments for later years are likely to be increasingly difficult to determine.

6. **What additional borrowing powers for current spending and for capital spending should the Scottish Government have?**

In our evidence to the Smith Commission and in previous evidence to the Finance Committee we have recommended that the Scottish Government should have additional revenue borrowing powers to fund preventative spending.

We are approaching this recommendation from the perspective that additional monies are needed to shift the balance between crisis spending on public services to preventative spending in order to achieve savings.

During this extended period of public spending restraint and increasing demand for public services, we support the development and roll out of arrangements which support a preventative spend agenda to achieve better outcomes for communities over the longer term. However, if transformational change is to take place within our public services, we believe that further revenue borrowing powers are needed.

At present Scottish local authorities can borrow to fund capital within the bounds of the Prudential Code and the Scotland Act 2012 gives limited borrowing powers over capital and revenue which will be extended further following the implementation of the Smith Commission recommendations. Neither the Smith Commission report nor HM Government’s ‘Scotland in the United Kingdom: An enduring settlement’ refer to preventative spending and their commentaries on borrowing powers, in our view, could not be interpreted as permitting revenue borrowing to fund the revenue aspects of preventative spend.

Borrowing for capital projects has always been viewed as preferable to borrowing to fund revenue expenditure on public services due to the benefits accrued from capital expenditure being spread over more than one financial year. A key overarching objective of preventative spending initiatives is to reduce demand for public services and create future savings. Therefore, preventative spending, like capital spending, is about investing in the future. We believe this provides clear justification for the extension of the Scottish Government’s revenue borrowing powers to fund preventative spend initiatives within prescribed limits.

Charities are major providers of public services and we believe that there is knowledge and experience within this sector which is vital to the success of preventative spending approaches. While there are a number of barriers to taking forward preventative spend initiatives, some of which could be overcome within the existing devolved arrangements, we believe that further revenue borrowing powers need to be devolved to support a shift away from crisis spend.

The debt financing of charities by government is a potential model for providing working capital to charities for preventative spend initiatives. However, debt financing, where interest is charged below commercial rates, has the potential to be caught by the EU State Aid rules. The State Aid rules were created to promote competition and control state subsidy levels so as to maintain a level playing field across Europe.

In practice, this means that government funding such as grants to a small enterprise, the creation of targeted tax reliefs to stimulate economic growth or investing in a framework to facilitate a move towards more preventative spending could be classed as ‘State Aid’ if certain criteria and tests are met. State Aid is a reserved matter: the UK Government can and does apply for exemptions when a case exists to boost growth and address areas of market failure. The Scottish Government’s State Aid Unit offers advice to the Scottish public sector on proposed public funding or assistance and compliance with the European
Commission’s State Aid rules. It pursues Scottish interests in respect of State Aid, acting as the Scottish interface on State Aid with the UK Government’s Department for Business, Innovation and Skills.

7. **What fiscal rules should be applied to these additional borrowing powers?**

Our response approaches the question on extending borrowing powers from the perspective of removing barriers to preventative spending which in turn has the potential to transform public services, improve lives and make savings.

Preventative spending does not guarantee success and therefore there are risks attached to it. Nevertheless, we believe that it is appropriate for the Scottish Government to be able to borrow to fund the revenue aspects of preventative spend initiatives, within an overall prescribed cash limit, where there is a realistic prospect of achieving savings. The resultant savings could reduce public spending in the long-term or free up resources which could be re-deployed elsewhere in the public services.

In addition to placing an overall cash limit on the amount the Scottish Government can borrow for preventative spending initiatives, we would envisage that borrowings would need to be repaid within a specified period of time and that governance arrangements would include measures to ensure that borrowings could not be used to fund recurrent revenue expenditure.

Borrowing must be affordable, sustainable and prudent and should be shared proportionately with future generations. Therefore, borrowing powers, in the context of the fiscal framework must be structured with these principles in mind whether these are exercised to fund shortfalls in taxation revenue or investment in assets or for preventative spending.

8. **How should inter-governmental machinery including the Joint Exchequer Committee be strengthened and made more transparent?**

Inter-governmental machinery requires a delicate balancing act, which ultimately must rest upon respect, trust and common interests. The machinery needs to be designed in order to facilitate the sharing of powers between different governments, and made strong enough to be effective but without taking on the powers themselves (intentionally or otherwise). It is also the case that these joint institutions can be caught in the middle, thereby becoming ineffective. As a result, inter-governmental machinery needs to operate under memorandums of understanding that are principles-based to provide clarity and transparency. They are also best served with appointments who understand both governments and who can establish the common interests, aims and objectives.

Intergovernmental relations would also be strengthened if there was an Office of the Regions, or similar, so that the devolving of powers, for example to Scotland, Northern Ireland and Wales, could be coordinated and also so that individual devolved authorities may learn from sharing experiences in a formal, coordinated forum.

At present, it would appear as though a significant number of governmental bodies and parliamentary committees, at both Westminster and Holyrood, are conducting work on aspects of the Smith implementation. However, from our perspective it would appear at times their respective workloads are overlapping and some efforts to coordinate this should be considered.

9. **What mechanisms should there be for reviewing the Statement of Funding Policy?**

We have no comments in relation to this question.

10. **What should be the role and remit of an enhanced Scottish Fiscal Commission and who should be responsible for generating the economic and fiscal forecasts?**

It is noted that the Scottish Government has put forward its proposals for an enhanced Scottish Fiscal Commission in its consultation on this topic, issued in March 2015; and that the proposed role is expected to evolve and grow as further powers are devolved,
following the implementation of both the Scotland Act 2012, and the Smith recommendations. No doubt, its role may also be developed by the deliberations of this inquiry and others.

ICAS will be submitting a separate submission to this consultation. It is key that the Scottish Fiscal Commission is independent and impartial, and the Smith Commission Report highlights the need for independent fiscal scrutiny. It may be beneficial to have the Commission on a statutory basis, but its independence is not necessarily obvious if it is a part of the Scottish Administration, and when one of its proposed functions is to prepare such reports as Scottish Ministers may require.

Its role should be as an independent examiner of the forecasts, budgeting and fiscal statistics.

11. **What lessons can we learn from the experience of other fiscal federations?**

   We have no comments in relation to this question.