

**SECOND ANNUAL REPORT ON THE
IMPLEMENTATION AND OPERATION OF PART 3
(FINANCIAL PROVISIONS) OF THE
SCOTLAND ACT 2012**

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

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

A year ago, the Rt Hon Michael Moore MP made the first annual report on implementation of these powers.

And just a year from now, two UK-wide taxes - Stamp Duty Land Tax and Landfill tax - will be switched off in Scotland and replaced by two new Scottish taxes introduced by the Scottish Parliament. The rates and thresholds for the new taxes will be set in Scotland; revenues from the new taxes will be collected in Scotland by a new Scottish tax administration; and the funds will be available for the Scottish Government to spend in whichever devolved areas it sees fit.

All of this as part of the United Kingdom, with the strength and support of the UK's economy and resources. This is devolution in action.

This Coalition Government made a commitment to people in Scotland to deliver the recommendations of the Calman Commission in our Programme for Government, and we have delivered.

The Scotland Act 2012 provides the greatest devolution of financial powers since the creation of the United Kingdom over 300 years ago. The Act increases the financial flexibility and accountability of the Scottish Parliament and Government to people in Scotland.

This implementation report – the second since the Scotland Act 2012 gained royal assent – sets out in detail the progress already being made towards strengthening Scotland's position within the UK. The Act will see full devolution of taxes on land transactions and landfill from April 2015, along with upgraded borrowing powers and a new cash reserve, and the creation of a new Scottish rate of income tax from April 2016.

Later this year, people in Scotland will make one of the most important collective decisions in their lifetimes – should Scotland remain part of a strong, successful United Kingdom, or should it become a new, separate state?

Some would have people in Scotland believe that when they make that choice, it is all or nothing; independence or the status quo. The Scotland Act illustrates why this is a false choice. Devolution is not a promise on the horizon – it is happening now.

The Scotland Act 2012 shows what the UK Government and Scottish Government can achieve when we work together. Our shared knowledge, experience and resources are what make us stronger together. We can be ambitious about the future, and we can deliver for people in Scotland.

The UK Government's position is clear - Scotland is better off within the United Kingdom, and the United Kingdom is better off with Scotland in it. I'm certain that many people, both in Scotland and in other parts of the UK, share that view.

I sincerely hope that this time next year, I am able to reflect on a year of further progress towards an even stronger Scottish Parliament within the United Kingdom.

A handwritten signature in black ink that reads "Alistair Carmichael." The signature is written in a cursive style, with the first letter of each name being capitalized and larger than the others. There is a horizontal line under the end of the signature.

Rt Hon. Alistair Carmichael MP
Secretary of State for Scotland

CHAPTER 1

INTRODUCTION

Scope and Content of this Report

1. This report on Part 3 of the Scotland Act 2012 is the second published since the Act gained Royal Assent on 1 May 2012.
2. Part 3 of the Scotland Act 2012 deals exclusively with the devolution of financial powers. These include:
 - the creation of a new Scottish rate of income tax;
 - the disapplication of UK stamp duty land tax in Scotland and provision for the introduction of a new Scottish tax on land transactions;
 - the disapplication of UK Landfill Tax in Scotland and provision for the introduction of a new Scottish tax on disposals to landfill;
 - provision for borrowing by Scottish Ministers; and
 - the power to create new devolved taxes.
3. The financial provisions will be implemented over a number of years, in line with the timetable set out in the Command Paper which accompanied the publication of the Scotland Bill in November 2010, to ensure that appropriate transitional arrangements are put in place. In order that both the UK and Scottish parliaments are fully informed through this process, section 33 of the Scotland Act 2012 requires the Secretary of State for Scotland and Scottish Ministers to report annually on the implementation of this part of the Act.
4. Both parliaments will be sighted on the views of both administrations: the Secretary of State for Scotland is required to report to the UK Parliament and provide a copy to Scottish Ministers who are required to lay it before the Scottish Parliament; and Scottish Ministers are required to report to the Scottish Parliament and provide a copy to the Secretary of State, who is required to lay it before both Houses of Parliament at Westminster. Both governments will continue to report until April 2020, or the first anniversary of

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

5. Section 33(5) of the Scotland Act requires the annual reports to contain:
 - (a) *a statement of the steps which have been taken, whether by the maker of the report or by others, since the making of the previous report (or, in the case of the first report, since the passing of this Act) towards the commencement of the provisions of this Part,*
 - (b) *a statement of the steps which the maker of the report proposes should be taken, whether by the maker of the report or by others, towards the commencement of the provisions of this Part,*
 - (c) *an assessment of the operation of the provisions of this Part which have been commenced,*
 - (d) *an assessment of the operation of any other powers to devolve taxes to the Scottish Parliament or to change the powers of the Scottish Ministers to borrow money, and of any other changes affecting the provisions inserted or amended by this Part,*
 - (e) *the effect of this Part on the amount of any payments made by the Secretary of State under section 64(2) of the 1998 Act (payments into the Scottish Consolidated Fund), and*
 - (f) *any other matters concerning the sources of revenue for the Scottish Administration (within the meaning of section 126(6) of the 1998 Act) which the maker of the report considers should be brought to the attention of the Parliament of the United Kingdom or the Scottish Parliament.*

6. *Annex A* provides a detailed list of the paragraphs in the report which address each of these requirements. However, the report is not limited to these requirements, and can also contain any other matters that each Government believes to be relevant or useful to both parliaments.

CHAPTER 2

SCOTLAND ACT 2012 IMPLEMENTATION PROGRAMME

Implementation of the Scottish rate of income tax and disapplication of Stamp Duty Land Tax and Landfill Tax in Scotland is delivered by HMRC through separate projects with oversight and governance provided by the Scotland Act implementation programme. The programme board includes representatives from HMRC, HM Treasury, the Scotland Office and the Scottish Government. Programme board members are involved in decision making to ensure that the projects deliver effective solutions and value for money.

Steps taken towards implementation since previous report

7. Major programmes and projects in central government are subject to OGC (Office of Government Commerce) GatewayTM Reviews, which provide assurance of the key stages so they can progress successfully to the next stage. In July 2013, the OGC undertook a Gateway 0 strategic assessment of the Scotland Act 2012 implementation programme which received an overall assessment of likely successful delivery of the programme. The review recommended continued close working with the Scottish Government to communicate the changes being introduced.
8. Further external assurance reviews of the implementation programme will take place over its lifecycle and a second OGC review is expected to be undertaken by the summer of 2014.
9. A joint communication group has been set up by HMRC and the Scottish Government to develop an integrated approach to communicating the changes introduced by the Scotland Act. The group includes representatives from HMRC's implementation projects, the Scotland Office, and Scottish Government partners involved in the delivery of the devolved taxes. The group has agreed a framework for communicating information about the introduction of the devolved taxes and will also develop an approach to

communicating the introduction of the Scottish rate.

10. The Statement of Funding Policy sets out the principle that the devolved administrations will meet all the operational and capital costs associated with devolution from within their allocated budgets¹. Information about the costs passed onto the Scottish Government as a result of the programme and individual projects is provided in the relevant sections of this report.
11. As set out in the first report, Edward Troup (HMRC's Tax Assurance Commissioner and Second Permanent Secretary) has been appointed Additional Accounting Officer for the Scottish rate of income tax. When he appeared before the Scottish Parliament's Public Audit Committee in 2012, he undertook to give evidence to the Scottish Parliament's committees when requested. In May 2013, he gave evidence to the Finance Committee to report progress on implementing the Scotland Act 2012 and has been invited to give evidence to the Committee again in May 2014. He also gave evidence to the Public Audit Committee in January 2014 on arrangements for auditing and reporting on HMRC's administration of the Scottish rate of income tax.
12. The Scottish Government is setting up Revenue Scotland to administer the devolved taxes and, in response to invitations from the Scottish Government, HMRC is represented on Revenue Scotland's tax administration programme and project boards, contributing to Scotland's development of systems to manage the devolved taxes.
13. Progress on the individual projects to implement the Scottish rate of income tax and disapply Stamp Duty Land Tax and Landfill Tax is discussed in greater detail in chapters 3, 4 and 5 of this report.

¹ *The Statement of Funding Policy can be accessed at:*
http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/sr2010_fundingpolicy.pdf

Further steps that will be taken towards implementation

14. In 2014-15, the programme will continue to provide oversight of the separate HMRC projects and the Board will meet regularly to consider progress towards implementation. HMRC has shared with the Scottish Government an estimate of approximately £5-6m for its work in 2014-15 to implement the programme and projects. A more detailed estimate of the cost of IT changes to deliver the Scottish rate of income tax will be available later in the year.

CHAPTER 3

SCOTTISH RATE OF INCOME TAX

From April 2016, the main UK rates of income tax will be reduced by 10 pence in the pound for those identified as Scottish taxpayers. The Scottish Parliament will set, in its annual budget, the new Scottish rate of income tax to be added to the reduced UK rates. The Scottish block grant will be adjusted to reflect this change in funding streams. Implementation of the Scottish rate is led by a HMRC project with representatives on the project board from HM Treasury, Scotland Office and the Scottish Government.

Steps taken towards implementation since previous report

15. The project has undertaken an examination of the information held by HMRC about where customers live to determine whether it is sufficiently accurate to form the basis for the identification of Scottish taxpayers. Work on comparing this data with alternative sources of information will continue in 2014-15 to ensure there is a robust basis for the introduction of the Scottish rate.
16. HMRC has invoiced the Scottish Government for £1,018,713 for costs associated with the project and implementation programme in 2013-14.
17. A more detailed examination of the work needed to introduce the Scottish rate has enabled a downwards revision of the overall estimate of the cost of implementation. The total cost is expected to be in the region of £35-£40m, in place of the original estimate of £40-£45m.
18. The non IT costs are estimated at £25m, less than the previous estimate of £30-35m. This is made up as follows:
 - £8.9m for issuing direct communications to Scottish taxpayers
 - £4.45m for the production of additional PAYE coding notices
 - £4.2m for project delivery costs
 - £4.2m for communications and publicity related activity

- £3.2m covers the remaining areas of impact and associated customer contact.

19. The project will work closely with HMRC's IT supplier in the next financial year to agree a firmer and more robust estimate of the IT costs of implementation. In advance of that work, HMRC estimate that the IT costs will fall within a range of £10-£15m. The cost may be higher than the previous estimate of £10m because of the need to accommodate the solution agreed to ensure that the correct amount of relief is given for pension contributions to relief at source schemes, and because HMRC have sought to introduce automated processes rather than manual wherever possible.

20. HMRC has started discussions with the Scottish Government and National Audit Office about the way in which revenue and expenditure associated with the Scottish rate will be shown in its annual accounts. Edward Troup appeared before the Scottish Parliament's Public Audit Committee in January 2014 alongside the Comptroller and Auditor General (C&AG). To ensure that the Scottish Parliament can have confidence in HMRC's operation of the Scottish rate of income tax, and the accuracy of its accounting, the UK Government introduced legislation in Finance Bill 2014 to require the C&AG to report direct to the Scottish Parliament on HMRC's administration of the Scottish rate.

21. An approach to ensuring that taxpayers get the correct income tax relief on pension contributions for individuals contributing through relief at source schemes has been agreed² after discussion with pension industry representatives and the Scottish Government. Pension providers will be given until 2018 to develop systems to ensure that Scottish taxpayers receive the right amount of tax relief by adjusting the amount that pension schemes claim from HMRC on their behalf.

² <http://www.hmrc.gov.uk/news/scottish-rate.htm>

22. In the interim, pension scheme administrators will continue to claim at the UK basic rate for all their members. If the Scottish Parliament decides that the Scottish rate should be different from the UK rate, HMRC will identify those who are Scottish taxpayers and make any adjustment for the Scottish rate to the value of their tax relief through the PAYE and Self-Assessment systems. Where this results in costs arising to HMRC, these will not be passed on to the Scottish Government. After 2018, pension providers themselves will be responsible for ensuring that their customers receive relief at the correct rate.

23. The two governments agreed that the decision on how Scottish taxpayers should be made aware of the amount of Scottish income tax they pay is one for the Scottish Government. In the light of consultation with representatives of employers, pension payers and payroll operators, the Scottish Government has asked for the Scottish rate to be shown separately in HMRC's online Tax Calculator, which enables individuals to estimate how much income tax they would pay based on their tax code and income, and in the annual Tax Summary provided by HMRC that will show individuals how their income tax was calculated for the previous tax year. Employers will be required to show the Scottish rate element of income tax separately in the annual statement of income tax liability (P60), which is issued to individuals after the end of the tax year showing deductions of tax and National Insurance Contributions. HMRC will consult employers on the specific changes required to the P60.

24. In February 2014, the OGC undertook a strategic assessment of the project which received an indication of likely successful delivery of the project.

Further steps that will be taken towards implementation

25. In 2014-15 the project will continue to develop the approach to identifying Scottish taxpayers. This will primarily be based on a further examination of HMRC data that can be used to determine a taxpayer's place of residence. Work will be undertaken to assess the level of accuracy of this information and associated cost implications identified if further work is needed to improve the quality of the data held. The project will share options and costs with the Scottish Government and they will be involved in decisions on the solution

through their membership of the project board.

26. The approach to communicating the changes needed to implement the Scottish rate will be developed and this is expected to include customer insight research to help identify customer needs. This will inform messages and how these are delivered. The project will present options and costs to the project board, including the Scottish Government, to determine the agreed way forward.

27. Work will also take place to prepare employers, agents, pension providers, software developers and payroll bureaux for the introduction of the Scottish rate.

CHAPTER 4

SCOTTISH TAX ON LAND TRANSACTIONS

The Scotland Act 2012 provides for Stamp Duty Land Tax (SDLT) to be fully devolved to the Scottish Government from April 2015. SDLT will no longer apply to land transactions in Scotland and the Scottish Parliament will be able to levy its own tax to replace it. HMRC's Scotland Act 2012 SDLT project manages the requirements for successful transition to the new Scottish tax, including the switch-off of SDLT in Scotland. The project board includes representatives from HMRC and the Scottish Government. Board members are consulted and involved at key decision points to ensure that the project provides effective solutions and value for money.

Steps taken towards implementation since previous report

28. The changes to HMRC's IT and business systems for switching off SDLT in Scotland have been identified in consultation with the Scottish Government. The Scottish Government will continue to supply HMRC with land transaction data after devolution to support HMRC's cross-tax compliance work and the work of other agencies (including the Valuation Office Agency). The process to manage this data flow has been subject to review with the Scottish Government and this has resulted in refinement of the process and costs associated with this requirement to ensure best value for money.
29. HMRC has so far invoiced the Scottish Government in 2013-14 for £147,609 in respect of this work.
30. The project is working closely with the Scottish Government on arrangements for the transition to minimise errors, uncertainty and disruption for customers. The project participates in the joint communications group with the Scottish Government to ensure a consistent and effective approach in communicating the changes to those affected.
31. HMRC estimates that the total cost of the project will be in the region of £1 million. This includes about £700,000 to £800,000 for IT changes to close

HMRC's systems for Scottish transactions and provide a channel for Revenue Scotland to deliver Scottish transaction data to HMRC after April 2015 for wider tax compliance purposes. The remaining element of the cost includes communications activities, in line with the joint approach agreed with the Scottish Government, to inform customers about the transition to the new Scottish tax and direct them to Revenue Scotland as appropriate, as well as operational delivery costs to implement business changes and in-house project governance costs. Some of these costs will fall in 2015-16, as a transitional period will be needed to embed the changes.

32. As the Scottish Government has been developing the legislative and administrative structure for the new Scottish tax, HMRC has provided data and information about how SDLT is structured, enforced and administered.

33. The design and implementation of the tax set up to replace SDLT is a matter for the Scottish Government and Parliament. On 31 July 2013, the Land and Buildings Transaction Tax (Scotland) Act gained Royal Assent, after passage through the Scottish Parliament. More information on the Land and Buildings Transaction Tax can be found in the Scottish Government's own annual report on implementation of the Scotland Act 2012.

Further steps that will be taken towards implementation

34. During 2014-15, HMRC will work with key stakeholders to ensure that changes to IT and business systems are understood to enable the successful transition from SDLT to LBTT in Scotland. From the date of transition, returns will not be accepted by HMRC in respect of land transactions in Scotland. Comprehensive customer guidance will be available in advance of this change, in line with the joint approach to communications agreed with the Scottish Government.

35. The UK and Scottish Government will agree the process for transition, setting out the requirements that will need to be met in order for the Commencement Order to be made to implement the Scotland Act 2012 provisions.

CHAPTER 5

SCOTTISH TAX ON DISPOSALS TO LANDFILL

The Scotland Act 2012 provides for Landfill Tax to be devolved. From April 2015, the UK tax will cease to apply in Scotland and the Scottish Parliament will be able to levy its own tax to replace it. The UK tax will be 'switched off' and a corresponding adjustment will be made to the Scottish block grant. HMRC's Landfill Tax project manages the requirements for successful switch-off of Landfill Tax including impacts on the landfill communities fund. The project board includes representatives from HMRC and the Scottish Government. Board members are involved in decision making to ensure that the project provides effective solutions.

Steps taken towards implementation since previous report

36. Due to the relatively small numbers of Landfill Tax operators affected by the changes being implemented, and the fact that relatively few changes are likely to be required to HMRC's systems, HMRC has been able to agree that any costs associated with the disapplication of Landfill Tax in Scotland will not be passed on to the Scottish Government.
37. The project participates in the joint communications group to ensure a consistent and effective approach to communicating the changes to those affected by the changes.
38. The design and implementation of the tax set up to replace Landfill Tax is a matter for the Scottish Government and Parliament. On 21 January 2014, the Landfill Tax (Scotland) Act gained Royal Assent, after passage through the Scottish Parliament. More information on the Landfill Tax (Scotland) Act can be found in the Scottish Government's own annual report on implementation of the Scotland Act 2012.

Further steps that will be taken towards implementation

39. In 2014-15, the project will focus on communicating the changes to Landfill Tax, ensuring that those affected are aware of the implications. HMRC will

continue to work with the Scottish Government to develop appropriate messages. This will include changes to the landfill communities fund and the introduction of processes for implementing the 2 year transitional period set out in the Command Paper published alongside the Scotland Bill, which allows for unspent landfill community funds at the time of transition to Scottish Landfill Tax to be spent on projects in Scotland as well as in the rest of the UK.

40. Draft legislation setting out the necessary changes to existing legislation for the disapplication of Landfill tax and the landfill communities fund will be published in autumn 2014.

41. The UK and Scottish Government will agree the process for transition from SDLT to the introduction of the Scottish tax, setting out the requirements that will need to be met in order for the Commencement Order to be made to implement the Scotland Act 2012 provisions.

CHAPTER 6

BORROWING POWERS OF SCOTTISH MINISTERS

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

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

Steps taken towards implementation since previous report

42. As set out in the previous implementation report, the two governments have agreed a process to enable Scottish Ministers to borrow from the National Loans Fund (NLF). This will be the source for all current borrowing.

43. For capital borrowing, the Scotland Act 2012 additionally provides for the Scottish Government to borrow from commercial banks and enables the UK Government to change the sources of borrowing through secondary legislation. The UK Government has announced that it will use this power to enable Scottish Ministers to issue bonds from 2015-16³.

³ <https://www.gov.uk/government/news/scotland-to-be-given-powers-to-issue-its-own-bonds>

44. Prior to the full implementation of borrowing powers in April 2015, Scottish Ministers are able to exercise a narrow version of these powers for specified capital expenditure with the agreement of HM Treasury. As set out in the previous report, from 2011-12, Scottish Ministers were able to use prepayments to fund early work on the Forth Road Bridge Replacement Crossing.

Further steps that will be taken towards implementation

45. The UK Government will work with the Scottish Government to make the necessary legislative changes to ensure that Scottish Ministers are able to issue bonds from 2015-16.

CHAPTER 7

POWERS TO DEVOLVE FURTHER EXISTING TAXES AND CREATE NEW DEVOLVED TAXES

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

46. As set out in the previous implementation report, the two governments have agreed a process for creating new Scottish taxes and/or devolving existing taxes. Any proposals will be discussed and agreed in principle by both governments prior to moving into a detailed assessment of the evidence base. The assessment phase is expected to include wider consultation on the proposals and should be commensurate with the likely impact of the proposal, including:

- the need to ensure that the proposed tax would not impose a disproportionate negative impact on UK macroeconomic or fiscal policy or impede the UK single market;
- the potential for the new tax to create or incentivise economic distortions within the UK;
- the potential of the new tax to create increased tax avoidance risks across the UK;
- the impact of the proposed tax on compliance burdens across the UK;
- the compatibility of the new tax with EU legislation and rules (for example, those on State Aid and the Single Market) and the Human Rights Act.

47. If Scottish and UK Ministers are content to proceed following the analysis phase, a legislative process will be taken forward in both the UK and Scottish

parliaments prior to the tax being implemented in, or devolved to, Scotland.

48. This power came into force on the same date as the Scotland Act 2012. To date, neither the Scottish Government nor the UK Government has put forward proposals to create new devolved taxes under this power.

CHAPTER 8

EFFECT OF NEW POWERS ON THE SCOTTISH BLOCK GRANT

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

49. **In relation to the Scottish rate of income tax**, the two governments agreed (through the Joint Exchequer Committee) to calculate the adjustment to the block grant using an 'indexed deduction' mechanism. This indexes the adjustment against the UK non-savings, non-dividends (NSND) income tax base.
50. This report provides more detail on how this mechanism will operate, both during the two or three transitional years and thereafter.
51. *In the two or three transitional years* starting in 2016-17, a forecast of Scottish rate revenues by the Office for Budget Responsibility (OBR) using the rate set by the Scottish Government will be paid to the Scottish Government alongside payments of the reduced block grant. The block grant adjustment will equal the forecast of revenues generated by a Scottish rate of 10 pence.
52. If the Scottish Government sets a rate of 10 pence during this period, the Scottish rate revenues will match the block grant adjustment and there will be no impact on the Scottish Government's budget compared to current arrangements. However, by setting a rate of 11 pence or 9 pence, the Scottish Government can still increase or decrease its budget (respectively)

compared to current arrangements, as the block grant adjustment will still be based on an estimate of the 10 pence forfeited by the UK Government.

53. These arrangements mean that no risk will be transferred to the Scottish Government during this transitional period, either in relation to growing the tax base in Scotland or managing forecast error. Both of these risks will be partly transferred to the Scottish Government post-transition.

54. In the first post-transition year of operation the same arrangements will operate as in the transitional years, but with the exception that there will be a year-end reconciliation process to recalculate the Scottish rate revenues and the block grant adjustment using actuals rather than forecasts.

55. This again means that a Scottish rate of 10 pence will deliver the same budget to the Scottish Government as current arrangements i.e. however much is generated by the Scottish rate (forecast or actual) will be deducted from the block grant.

56. Equally, a Scottish rate of 11 pence or 9 pence will again enable the Scottish Government to increase or decrease its budget (respectively) compared to current arrangements, as the block grant adjustment (forecast or actual) will still be based on an estimate of the 10 pence forfeited by the UK Government.

57. However, performing the reconciliation process at the end of the year will additionally:

- (a) ensure the correct starting point for the calculation of the indexed block grant adjustment in subsequent years; and
- (b) transfer to the Scottish Government responsibility for forecast error in the NSND tax base in Scotland over and above the forecast error for this tax base in the UK as a whole.

58. Any over- or under-payments from the UK Government to the Scottish Government identified during this process (because actuals differ from the forecasts on which the payments were originally based) will be reflected in the block grant for the financial year following the reconciliation process.

59. In the second post-transition year onwards the adjustment made in the previous year is indexed against movements in the UK NSND income tax base. This means that if the UK NSND income tax base contracts by 2%, the size of the adjustment to the block grant will decrease by 2%; if the tax base grows by 2%, the adjustment will increase by 2%.

60. This adjustment mechanism therefore provides incentives and enhances the accountability of the Scottish Government as its budget will be directly affected by the performance of the Scottish economy. Specifically:

- If the Scottish Government sets a rate of 10 pence and the NSND tax base in Scotland grows faster than the UK average, then its budget will be higher than it would be under current arrangements. Equally, it would be lower if growth in Scotland is slower than the UK average. This transfers to the Scottish Government the risk that the NSND tax base in Scotland grows at a different rate than in the UK; and
- The Scottish Government can still further vary the size of its budget by setting a Scottish rate of income tax which is higher or lower than 10 pence.

61. This adjustment mechanism also protects the Scottish Government's budget from UK-wide macro-economic shocks, which the UK Government is better placed to manage. For example, if the UK NSND tax base contracts by 10% then the adjustment to the block grant will also be reduced by 10% (so the block grant element of the Scottish Government's budget is increased).

62. Both the Scottish rate revenues paid to the Scottish Government and the UK NSND income tax base, which determines the block grant adjustment, will initially be based on forecasts. As in the first post-transition year, there will be a year-end reconciliation process (around 12 months after the end of each financial year) whereby both of these forecasts are replaced with actuals. Any over- or under-payments from the UK Government to the Scottish Government will be reflected in the block grant for the financial year following the reconciliation process.

63. **In relation to stamp duty land tax (SDLT) and Landfill Tax**, the two governments continue to work together to consider how Scotland's block grant should be adjusted. The Command Paper published alongside the Scotland Bill stated that there would be a one-off adjustment that would be applied in all future years. It also stated that the process should be equitable to both the UK and Scottish Governments and Parliaments and based on the best data available, including outturn tax receipts data as well as the tax receipts forecast carried out by the independent OBR.

64. This approach, without ongoing indexation against the corresponding UK tax base, will require the Scottish Government to manage the full volatility of the smaller devolved taxes, for which it is being provided with extended current borrowing powers and a cash reserve. However, it has been more difficult to determine the nature of a one-off adjustment that is likely to be equitable to both Scotland and the UK in the longer-term; specifically, a one-off adjustment that reflects not only the revenues currently generated by these taxes but also the longer term prospects.

65. The UK Government is attracted to an adjustment based on the approach taken when business rates were devolved to Scotland. This involved a one-off adjustment comprising two elements:

- reducing the block grant baseline; and
- updating the business rates Barnett comparability factor from 100 per cent to 0 per cent.

The Scottish Government retained all business rates revenues in place of the baseline deduction, and all growth in these revenues in place of future business rates Barnett consequentials.

66. A similar approach could be taken for SDLT and Landfill Tax, albeit through making all Barnett consequentials slightly smaller as there aren't specific comparability factors for these taxes. The two elements of the proposed adjustment would need to be negotiated, but they could respectively reflect the revenues currently generated by these taxes and the longer-term

prospects. The two taxes could also be considered together or separately. The UK Government has proposed this adjustment mechanism. The Scottish Government has recently responded to the proposal, outlining an alternative approach, which the UK Government is now considering.

67. The UK Government has also now opened similar discussions with the Welsh Government in relation to the full devolution of SDLT and Landfill Tax in the Wales Bill, which was introduced on 20 March 2014 and which delivers greater fiscal powers to the Welsh Government and Assembly. The Wales Bill Command Paper provides further details on the UK Government's proposed approach to the block grant adjustment, which is consistent with the approach outlined above.

CHAPTER 9

OTHER ACTIVITIES TOWARDS IMPLEMENTATION

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

Scottish rate of income tax: consequential issues

69. Last year's report explained that HMRC had published a Technical Note setting out how the UK Government intended to manage a number of consequential issues arising as a result of the Scottish rate, including the rate of relief for charitable giving and treatment of income from trusts. Among other things, this confirmed that, following consultation, Gift Aid repayments to charities would continue to be made at the UK basic rate to minimise administrative burdens on charities. A measure has been included in Finance Bill 2014 which makes changes to the structure of the income tax legislation so that subsequent secondary legislation can be made to apply the proposals in the Note effectively.

70. The measure will not alter the calculation of the rates of tax paid by Scottish (or other) taxpayers. Regardless of these changes to the structure of the legislation, future reports under Section 33 of the Scotland Act will continue to cover the full range of activity in implementing the Scottish rate.

Scottish rate of income tax: tie-break

71. The Wales Bill will implement key proposals from the Commission on Devolution in Wales (Silk Commission 1st report). This includes, subject to a referendum, a Welsh rate of income tax structured along the same lines as the Scottish rate.

72. The Scotland Act 2012 provides that a person will be a Scottish taxpayer if they have a main place of residence in Scotland for at least the same amount of time as they have elsewhere in the UK. Alternatively, if they do not have a main place of residence, but spend at least the same number of days in

Scotland as in another part of the UK, they will be a Scottish taxpayer for the whole of the tax year in question. Additionally, if an individual is a Scottish parliamentarian for any part of a year they are a Scottish taxpayer. The definition of a Welsh taxpayer therefore could not be identically drafted to the provision in the Scotland Act as this would mean that it would be legally possible for an individual to be both a Scottish and Welsh taxpayer in the same tax year. The Wales Bill therefore provides for amendments to be made to the definition of a Scottish taxpayer if the Welsh rate is introduced so that this will not happen.

Forecasts by the Office for Budget Responsibility

73. The Office for Budget Responsibility (OBR) began to publish forecasts of Scottish taxes in March 2012. Further forecasts were published following each subsequent Budget and autumn statement. The OBR will continue to publish these forecasts twice a year, and will generate forecasts taking into account tax rates and bands for the Scottish taxes once they are known, with the next update due in the autumn of 2014⁴.
74. This includes a forecast of Aggregates Levy, which has not been devolved as it is currently subject to state aid investigations and a legal challenge in the European Courts. The UK Government will keep this under review and in the meantime, the OBR will continue to forecast the share of Aggregates Levy revenues attributable to Scotland.

Cash reserve

75. The cash reserve provides the Scottish Government with a further tool, alongside current borrowing, to help manage the new tax powers.
76. From 2015-16, the Scottish Government will be able to maintain a reserve using an element of tax revenues, which can be accessed if future tax revenues are lower than forecast.

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

77. In order to support the transition to the new system, Scottish Ministers can currently make discretionary payments into the cash reserve until June 2016 up to an overall total of £125 million. No such payments have yet been made.

Budgeting arrangements for devolved powers

78. Budgeting arrangements are being developed to support the Scottish Government's spending funded by devolved tax revenues and borrowing.

79. HM Treasury has shared proposals with the Scottish Government that are based on arrangements already in place in relation to the Northern Ireland Executive's spending that is funded by local tax revenues (council tax and business rates) and borrowing⁵.

⁵ The Northern Ireland Executive is responsible for many of the functions performed by local authorities in the rest of the UK. This includes the collection of council tax and business rates and the corresponding borrowing powers.

CHAPTER 10

OTHER REPORTING REQUIREMENTS

80. In addition to the areas covered above (steps taken towards implementation, steps yet to be taken and effect of provisions on the block grant), section 33 of the Scotland Act 2012 requires annual reports on Part 3 of the Act to include:

- an assessment of the operation of the provisions of Part 3 which have been commenced;
- an assessment of the operation of any other powers to devolve taxes to the Scottish Parliament or to change the powers of the Scottish Ministers to borrow money, and of any other changes affecting the provisions inserted or amended by this Part;
- any other matters concerning the sources of revenue for the Scottish Administration (within the meaning of section 126(6) of the 1998 Act) which the maker of the report considers should be brought to the attention of the Parliament of the United Kingdom or the Scottish Parliament.

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

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

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

CONCLUSION

83. The past year has seen us move closer to the full implementation of the Act. Next year's introduction of the Scottish taxes to replace SDLT and Landfill Tax will see more financial accountability and flexibility for the Scottish Parliament.
84. Clearly, there remains some work for the two governments before this important step forward takes place but the UK Government is confident that working together with the Scottish Government, we will bring the new powers into operation successfully and in line with the timescales set out in the Command Paper laid alongside the Bill in 2010.
85. The next annual report on the implementation of Part 3 of the Scotland Act 2012 will be published, in accordance with Section 33(3)(b) of the Scotland Act 2012, before 1 May 2015.

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

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

Chapter 2: Paragraphs 7 - 13

Chapter 3: Paragraphs 15 - 24

Chapter 4: Paragraphs 28 - 33

Chapter 5: Paragraphs 36 - 38

Chapter 6: Paragraphs 42 - 44

Chapter 7: Paragraphs 46 - 48

Chapter 9: Paragraphs 68 - 79

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

Chapter 2: Paragraph 14

Chapter 3: Paragraphs 25 - 27

Chapter 4: Paragraphs 34 - 35

Chapter 5: Paragraphs 39 - 41

Chapter 6: Paragraph 45

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

See chapter 10.

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

See chapter 10.

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

Chapter 8: Paragraphs 49 - 67

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

See chapter 10.



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