Memorandum of Understanding
Concerning the Scottish Rate of Income Tax

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Introduction

The purpose of this paper is to discuss the draft memorandum of understanding (MOU) prepared by the Scottish Government (SG) and Her Majesty's Revenue and Customs (HMRC) for the establishment and operation of the Scottish Rate of Income Tax (SRIT).

With the freedom to partially control rates of income tax in Scotland comes added risk. Any agreement between the Scottish Government and HMRC about the processes concerning the operation of SRIT should ensure that the risks facing SG are known, measurable and consistent with the legislative intent embodied in the Scotland Act 2012.

The Memorandum of Understanding

Para 1.1: The SRIT is not a devolved tax in the sense of being administered and collected by the Scottish Government. Rather it is a UK tax administered by HMRC with Scottish ministers having the sole power to set the Scottish rate. This implies a clear division of responsibility that will not impose the costs of setting up a tax administration structure on SG.

Para 1.3: The arrangements for accounting officer and responsible officers seem comprehensive. There will be an Intergovernmental Assurance Board (IAB) to oversee planning and implementation of SRIT. In addition, the Joint Exchequer Committee (JEC) will provide ministerial oversight. The role of the JEC is to focus on the implementation of the Scotland Act. In this context, the accounting arrangements seem likely to provide mechanisms which will reduce the risk of disagreement between SG and HMRC and therefore reduce the risk of SG facing unforeseen risks.

The IAB will have a key role in ensuring that the implementation of IT and non-IT systems in support of SRIT by HMRC is satisfactory. It is therefore essential that IAB operates efficiently and in an intergovernmental fashion. HMRC is to invoice SG for the costs of implementing SRIT. These costs will follow HM Treasury policy which means that the full economic cost of providing the service will be charged to SG. The MOU makes it clear that HMRC is to keep SG informed of timetables and estimated costs. However, given that HMRC is the monopoly seller of these services to SG, it is essential that there is complete a transparency and accountability for these costs to mitigate the risk of unforeseen additional costs to SG.

Para 2.2: SG will have the opportunity to test the IT systems developed by HMRC. The efficient running of these systems is essential to reduce the risk of maladministration in the application of

SRIT. It would perhaps be useful to the Finance Committee to better understand how these assurance procedures will operate and what assurance of their successful operation might be provided.

Para 3.2: Scottish taxpayers are to be identified with a specifically Scottish tax code. The identification of Scottish tax payers is the responsibility of HMRC. This includes those paying tax through the Self-Assessment (SA) system. One issue of which the Finance Committee and SG will have to be aware is the potential for the self-employed, who mainly pay under the SA system, to change their incorporation status in response to differentials between Scottish and RUK rates of income tax.

The Finance Committee may also wish to ensure that it is informed of HMRC practices in relation to cases where Scottish tax paying status is not clear cut. Thus, for example, the classification of single individuals who maintain residences in both Scotland and England and who work in both jurisdictions may prove problematic.

Para 3.4: HMRC have agreed to enforce compliance and anti-avoidance activity equally to both Scottish and RUK taxpayers. SG may ask HMRC, at a cost, to carry out additional compliance activity to reduce revenue risk. Again, this is only likely to be an issue should large differentials in tax rates emerge between Scotland and RUK.

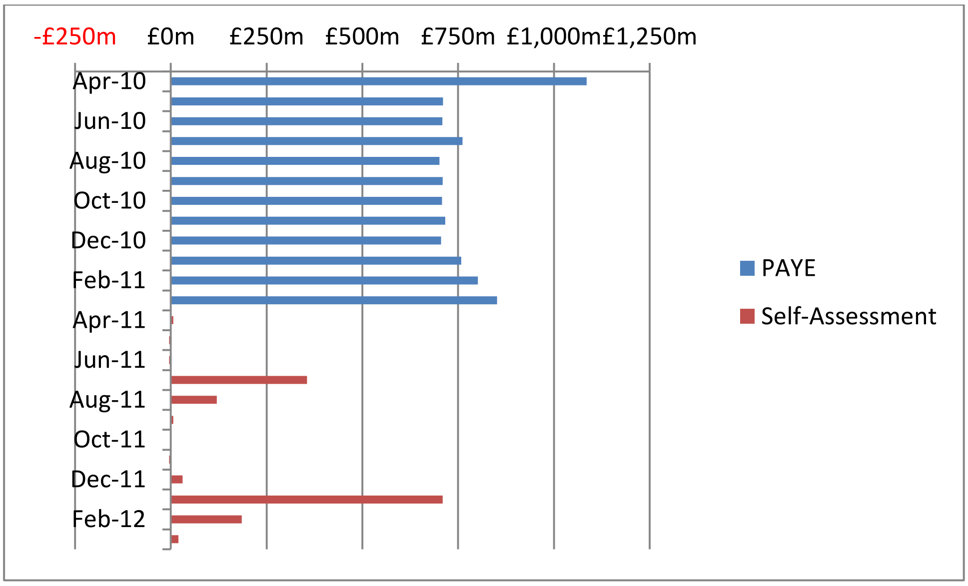
Para 4.2: The MOU sets out a clear set of costs to be borne by SG on the one hand and HMRC on the other. This is a useful clarification, though the Committee will wish to be assured that it is exhaustive. The Committee may also wish to monitor how these costs evolve.

Para 4.5: The dispute resolution procedure allows for escalation of conflict from the Programme Board on which SG is represented to the IAB and finally to the JEC which has the power to impose a decision. The JEC comprises the Chief Secretary to the Treasury, the Secretary of State for Scotland and the Exchequer Secretary, representing the UK Government. SG is represented by the Cabinet Secretary for Finance, Employment and Sustainable Growth and the Cabinet Secretary for Parliamentary Business and Government Strategy. Although UK ministers are in the majority, the minutes of the first meeting of the JEC suggest that there is “a clear and shared ambition and an expectation to reach agreement on matters brought to the JEC for decision” rather than having decisions imposed by the UK Government. It is not clear how whether such a collegiate approach can be guaranteed.

__Para 5.1:__ The establishment of the timetable for SRIT and its implications both for parliamentary scrutiny and for revenue risk is another key issue that is addressed in the MOU. Some additional background is provided in Figures 1 and 2.

Figure 1: Simulated Pattern of Receipts for Income Tax in Scotland 2010-11:

Total Receipts = £10,634m



Source: HM Revenue and Customs Receipts Nov 2012, Government Expenditure and Revenue in Scotland 2010-11

Figure 2: Timetable for setting and collection of SRIT

__Key Dates__	*__Month__*	*__Tax Paid__*	*__UK Govt. Payments__*	*__Share of SRIT Revenue__*
SG makes decision on tax rate	Nov			
Parliamentary Scrutiny	Dec			
	Jan			
	Feb			
Budget bill passed	Mar			
Beginning of financial year	Apr	PAYE returns	Block Grant Installment	84%
	May to Mar	PAYE returns	Block Grant Installments	
Next financial year	Apr to Jun			
Manual self-assessment due	Jul	SA Payment		6%
	Aug to Dec			
On-line self-assessment returns due	Jan	SA Payment		10%

Figure 1 is a simulation of the monthly pattern of income tax payments in Scotland. It is based on the assumption that this pattern will not differ significantly from that in the rest of the UK. The key characteristics of this pattern are steady monthly PAYE payments and delayed and much more volatile payments through the SA system. Figure 1 shows a monthly pattern that is consistent with the overall income tax receipts for Scotland in 2010-11 of £10,634 million. 84% of this total is accrued within the financial year through the PAYE system. The remaining 16% is accrued mainly in July and January of the following tax year, resulting from the manual self-assessment returns due in July and the online assessment returns that are due the following January . SRIT is likely to account for around 42% of total income tax revenue in Scotland, suggesting that SA payments in relation to SRIT would be of the order of £700 million. This would be the most risky and least predictable component of SRIT revenues and therefore the most likely to require hedging to reduce risk. Figure 1 also shows regular monthly block grant payments coming to the Scottish Government from the UK government during the financial year.

Para 5.1: Figure 2 shows the timetable for setting the SRIT rate. If the tax codes have not been determined by the Scottish Parliament by the end of November, HMRC will have to work on an agreed assumption for the issuance of tax codes. It might be worth the committee investigating how this assumption would be set, since errors in tax coding will have to be subsequently corrected with potential administrative and revenue costs to SG.

Para 6.1: The Office for Budget Responsibility (OBR) plays a key role in forecasting SRIT receipts. The forecasting track record of the OBR is fairly weak. In addition, the forecast methodology which the OBR proposes to adopt is based on calculating Scotland's share of UK income tax receipts using data from the Survey of Personal Incomes, a survey which has significant limitations.

Given that the OBR forecast will be incorporated into the calculation of SG's total budget and the block grant, there is clearly an element of forecast risk. It may be worth the Finance Committee engaging with the National Institute of Economic and Social Research, which is developing an ESRC-funded model of the Scottish economy, to take its own view of the prospects for income tax receipts in Scotland.

Para 6.2: The Finance Committee will wish to take a view about how to deal with to the Annual Report on SRIT provided by the National Audit Office. Clearly, the Finance Committee would have the responsibility for interacting with the Additional Accounting Officer appointed by HMRC to deal with SRIT

Conclusion

In general, the MOU provides a solid basis for the administration of SRIT by HMRC in which the SG should be aware of the risks involved in the process and associated costs. Nevertheless, there are possible issues highlighted in this paper that the Finance Committee may wish to address. The Committee will wish to ensure that the risks are minimized and that its own role within the process of setting and analyzing the Scottish Rate of Income Tax is clearly understood and established.