SCOTTISH GOVERNMENT FIRST ANNUAL REPORT ON THE IMPLEMENTATION AND OPERATION OF PART 3 (FINANCIAL PROVISIONS) OF THE SCOTLAND ACT 2012

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Foreword

Under section 33 of the Scotland Act 2012 both the Scottish and UK Governments are required to report progress annually on implementing the provisions of the Scotland Act to both the Scottish and UK Parliaments. The requirement to provide such reassurance to Parliaments formed part of the agreement between the governments that allowed the Scottish Parliament to agree to a legislative consent motion for the Act in April 2012. The Scottish Government has also made clear that it will seek the Scottish Parliament's agreement to changes to Scotland's funding arrangements, now and in the future, in order to provide democratic oversight and assurance that Scotland's interests are being properly considered.

The Scottish Government believes that the interests of Scotland and the people living here will be best served by Scotland taking responsibility for all fiscal powers, including taxation and borrowing – as part of the range of powers that all independent countries exercise. This means that key decisions will be made here by those who have Scotland's best interests at heart and who have a direct stake in its success. That is the change that the people of Scotland will be able to choose when they participate in the referendum on independence on 18 September 2014.

In the meantime, the Scottish Government regards it as very important that the Parliament and people of Scotland receive a full account of our progress and that of the UK Government in implementing the provisions of the Scotland Act on their behalf. I look forward to Parliament's scrutiny of this report and that process.

JOHN SWINNEY
Cabinet Secretary for Finance, Employment and Sustainable Growth

Devolved Taxes

1. This section describes progress with implementing those powers in the Scotland Act dealing with devolved taxes. The relevant powers will be implemented from April 2015. The section reports on progress to date, and sets out plans for further activity over the period ahead. None of the relevant powers has yet been implemented, nor has there been any further devolution of taxes beyond those set out in the Act at the time of enactment, so this section does not comment on these issues. Nor does it comment on the effect of devolved tax powers on the Scottish block grant. This depends on arrangements for the block grant adjustment and is covered in that section of the report. The Scottish rate of income tax is discussed separately.

The Scottish Government's proposals

2. The Scotland Act, enacted on 1 May 2012, devolved to the Scottish Parliament power to legislate for a tax on transactions involving interests in land, and for a tax on disposals to landfill. In a statement to the Scottish Parliament on 7 June 2012, the Cabinet Secretary for Finance, Employment and Sustainable Growth indicated that the Scottish Government would bring forward for scrutiny by the Parliament legislative proposals for both devolved taxes. The Cabinet Secretary also set the direction for devolved taxes in Scotland, emphasising that the burden they imposed would be proportionate to the ability to pay and that taxes would be efficient to administer, convenient to pay, and certain in their effect. On tax collection, the Cabinet Secretary said that the Scottish Government had decided to establish a Scottish tax authority, to be called Revenue Scotland. It would work closely with Registers of Scotland to administer the devolved tax on land transactions and with the Scottish Environment Protection Agency (SEPA) on the devolved tax on landfill.

Land and Buildings Transaction Tax

3. Since then, good progress has been made. Consultation on the proposed Land and Buildings Transaction Tax (LBTT) began on 7 June 2012 and ran to 30 August. An LBTT Bill was introduced on 29 November 2012. Key features of the proposed tax include a progressive structure in place of the slab structure of Stamp Duty Land Tax which LBTT will replace; a different approach to the taxation of non-residential leases; and changes to some tax reliefs.

4. The Scottish Parliament started its Stage 1 scrutiny of the Bill in January, holding 5 oral evidence sessions with a wide range of witnesses. The debate on the Stage 1 report takes place on 25 April. The Bill is scheduled to complete its parliamentary stages by the end of June. Thereafter, subordinate legislation on a range of matters set out in the Bill will be required. Guidance on the detail of the tax, how it will operate and what this means for taxpayers and their agents will be prepared, involving Revenue Scotland and Registers of Scotland. The Scottish Government has indicated that it expects to propose tax rates and thresholds at the time of the draft

Budget for 2015-16. These will require Scottish parliamentary approval under powers set out in the LBTT Bill. The tax is expected to come into operation at the beginning of April 2015.

Scottish Landfill Tax

5. A consultation on a Scottish landfill tax began in October 2012 and concluded in January 2013. Key features included the proposal that unlicensed disposals should be subject to tax in Scotland; and that rates and structure of the tax should broadly mirror those in place under the existing UK landfill tax regime to avoid cross-border imbalance. The Government has also proposed that a Scottish landfill communities fund, payments to which would earn tax credits for landfill operators, should be established. The criteria would be consulted on further, but it is proposed that there should be a higher credit cap than under current UK arrangements.

6. The Scottish Landfill Tax Bill was introduced to the Scottish Parliament on 17 April. It will be scrutinised by the Finance Committee. Building on the consultation responses and on-going engagement with industry, the main change from the existing UK landfill tax is to include provisions that will allow unauthorised waste deposits (e.g. illegal dumping) to be taxed. The Bill is scheduled to complete its parliamentary stages by early 2014. Thereafter, subordinate legislation will be prepared under powers set out in the Bill and guidance for taxpayers will be developed, involving Revenue Scotland and SEPA. This will include information on the tax, how it will operate and what this will mean for taxpayers and their agents.

Tax Management Bill

7. The Scottish Government has indicated that it intends to introduce a Tax Management Bill addressing the administrative arrangements for all devolved taxes. A consultation document was published in December 2012, and the consultation ended on 12 April. It set out proposals for placing Revenue Scotland on a statutory basis, and conferring powers and duties on it. The proposals also cover the duties of taxpayers, arrangements for securing compliance, settling tax disputes including arrangements for handling appeals, tackling avoidance, and handling of taxpayer information. Responses to the consultation are now being considered. The Scottish Government has indicated that it intends to introduce a Bill in autumn 2013 for parliamentary scrutiny.

Revenue Scotland

8. The Cabinet Secretary set out in his statement of 7 June 2012 broad proposals for establishing Revenue Scotland. The new body will work with Registers of Scotland and SEPA to administer and secure compliance with the devolved taxes. Revenue Scotland will build on the work that these existing bodies already do in registering land transactions in Scotland and in regulating disposals to landfill. This will enable the new body to operate more efficiently and flexibly, and at lower cost than was estimated by Her Majesty's Revenue and Customs (HMRC) for the administration of the devolved taxes in Scotland assuming that they mirrored the current UK taxes. An estimate of

Revenue Scotland etc. costs was placed in the Parliament's information centre (SPICe) in June 2012.

9. As noted, the proposed Tax Management Bill will make proposals for establishing Revenue Scotland on a statutory footing, with a structure and governance arrangements reflecting the options set out in the consultation paper and any views expressed in response. In the meantime, the new body exists as an administrative entity within the Scottish Government. The Head of Revenue Scotland was identified in autumn 2012 and has been in post since 1 October. Key staff are being recruited, among them a Chief Operating Officer who has direct experience of tax administration, including the existing UK SDLT. The body will have 9 staff from June 2013. A programme of work has been established with Registers of Scotland and SEPA to oversee design and development of systems, training, guidance, structures and other arrangements to ensure that the devolved taxes can be collected efficiently and effectively from April 2015. Revenue Scotland is engaging in dialogue with taxpayers and their agents in Scotland.

10. Revenue Scotland is also working with HMRC on arrangements for "switching off" the UK taxes that will cease in Scotland from April 2015. This includes developing transitional arrangements, and work to ensure that taxpayers are properly prepared and that systems can handle the transition successfully. Costs incurred by HMRC are being met by the Scottish Government. In 2012-13, these costs amounted to £18,153. They arose from work on the SDLT switch-off project. Costs in future years will be met from the appropriate budget as described in paragraph 25 below. Initial estimates provided by HMRC indicated that part of the work involved in "switching-off" SDLT and Landfill Tax would cost in excess of £500,000. Work is underway to provide an estimate of the full amount and the results are expected in 2013.

New taxes

11. The Scotland Act also gives the UK Government power to add to the Scottish Parliament's legislative competence by devolving responsibility for further taxes, by Order, with the agreement of the Scottish and UK Parliaments. To date, no proposals have been made for this power to be used. However Ministers of the Scottish and UK Governments have discussed and agreed in outline arrangements for considering any such proposals should they be brought forward. The Scottish Government continues to press for Air Passenger Duty to be devolved to Scotland, noting that the Northern Ireland Executive has been given devolved power over aspects of APD in Northern Ireland.

Borrowing Powers

12. This section describes progress with implementing the powers in the Scotland Act dealing with borrowing. As with devolved taxes, it reports on progress to date and future plans. The relevant powers will be implemented from April 2015. There will be no effect on spending power in Scotland until then.

Capital Borrowing

13. The Scotland Act enables Scottish Ministers to borrow for capital purposes up to a cumulative maximum of £2.2 billion. HM Treasury have made clear that borrowing in any one year must not exceed 10% of the Scottish Government's capital Departmental Expenditure Limit (CDEL) which restricts annual borrowing to approximately £240 million. Borrowing may be through the UK Government from the National Loans Fund, or by way of a commercial loan (directly from a bank or other lender). The Scotland Act also gives the UK Government power to expand the range of ways in which the Scottish Government can borrow to include the issue of bonds. The UK Government has consulted on using this power but has not yet reached a decision. The Scottish Government has argued that it should have the power to issue bonds should it choose to do so.

14. The Scottish and UK Governments have discussed and agreed arrangements for capital borrowing from the National Loans Fund. In brief, the Scottish Government will be expected to provide an estimate of its expected capital borrowing from the NLF before the beginning of the year in which the borrowing will take place. Loans can then be requested in-year up to the annual limit, with approximately 5 working days' notice. Normal NLF terms will apply. This means that the Scottish Government would be able to select the type of loan (e.g. equal instalments of principle or repayment of principle at term). The term of any loan would normally be for 10 years, but where the lives of the assets being purchased through the loan justify longer or shorter terms, these can be agreed. Interest rates will be those prevailing at the time for any NLF borrower. For example, the current NLF interest rate for a 10-year loan repaid through equal instalments of principle is approximately 1.1%.

15. The Scottish Government will be responsible for setting up systems to record and repay loans. The Scottish Government will be able to apply funds borrowed in this way to any capital investment. Loans will appear in the Scottish Government's balance sheet as a liability and will be subject to audit.

16. The Scottish Government is discussing with officials of the Parliament arrangements for providing information about borrowing in the context of future draft Budgets.

17. No arrangements have yet been made in relation to borrowing by the Scottish Government by way of commercial loans from banks or other lenders.

Revenue Borrowing

18. The Scotland Act enables the Scottish Government to borrow for certain revenue purposes up to a maximum of £500m. Treasury have indicated that the limit in any one year would be £200 million. Such loans are to be repaid within 4 years. The purpose of these loans is to help smooth fluctuations in tax receipts. In particular, revenue borrowing will be available to provide bridging funding where actual tax receipts fall short of forecasts and where the alternative would be for the Scottish Government to have to reduce spending in-year. The intention is that borrowing of this kind would be available in relation to both devolved tax receipts (and therefore effective from 2015-16) and receipts from the Scottish rate of income tax following the transitional period (from 2018-19 or 2019-20).

19. The Scottish Government is discussing with HM Treasury the circumstances in which this borrowing would be accessed, and the arrangement for doing so, with a view to the arrangements being in place and available for use from 2015 onwards. Use of revenue borrowing would not, because of its nature, be planned in advance of the need arising.

Scottish Cash Reserve

20. The Command Paper "Strengthening Scotland's Future" set out proposals for a Scottish Cash Reserve. The concept is that from 2012-13 the Scottish Government can set aside funds from current budgets (and, from 2015-16, a proportion of receipts from devolved taxes) in a reserve for release in future years when particular criteria are met. This is intended to give the Scottish Government three options when receipts fall below forecast – first, to use funding from the cash reserve; second, to have recourse to revenue borrowing; and third, to cut expenditure in-year.

21. As with revenue borrowing proposals, the Scottish Government is discussing how in practice the proposed cash reserve would operate and in particular the circumstances in which funds set aside in previous years from Scotland's budget or tax receipts could be released to support current expenditure.

Scottish Rate of Income Tax

22. This section describes progress with implementing the Scottish rate of income tax (SRIT), and also comments on future plans. On present plans, SRIT powers will be implemented from April 2016. Scottish taxpayers are defined in the Scotland Act. All Scottish taxpayers will see their rate of UK income tax reduced by 10p in the pound across each income tax band. The Scottish Parliament will be able to pass a Resolution setting a Scottish rate to replace the 10p reduction. The tax will be administered by HMRC, who will therefore be responsible for setting up the necessary systems, identifying Scottish taxpayers, collecting sums due, ensuring compliance, following up unpaid tax, and reporting on performance. Revenues from SRIT will be collected by HMRC along with UK income tax receipts, but will be identified and reported separately and will form an element of the Scottish Government's budget after 2016 under the UK Government's plans. The block grant adjustment in respect of SRIT will also be applied to the Scottish budget.

23. The costs of establishing and operating SRIT are to be met by the Scottish Government. The UK Government provided an initial estimate in November 2010 when the Scotland Bill was introduced of £40 million to £45 million for set-up costs in the period to March 2016, and about £4.2 million a year in running costs thereafter.

24. One of the first tasks of the SRIT project is to develop a detailed, costed plan for the necessary work. HMRC are leading this and work is under way. The project is subject to standard HMRC governance arrangements, including external Gateway review. A Scottish Government official sits on the project board and has access to all project papers. The planning work includes identifying key decision points, and also arrangements for engaging with Scottish taxpayers and employers affected by the changes. Where decisions would have an impact on Scottish taxpayers and employers, and / or on the costs of the project and on matters of communication and engagement, HMRC will consult Scottish Government officials. Where necessary, the views of Scottish Ministers will be sought.

25. It is too early in the work of preparing the detailed plans to say whether any savings will be possible on the original broad brush cost estimates. Some initial costs have arisen in 2012-13, amounting to £165,141 in total. These have been met by the Scottish Government from the Administration budget. The Scottish Parliament has approved a budget for 2013-14 that includes £3.5 million for the costs of implementing the financial provisions in the Scotland Act. This total has been set aside to cover costs of the SRIT implementation project, costs arising from the projects to "switch off" Stamp Duty Land Tax and Landfill Tax in Scotland from April 2015, and costs incurred by RoS and SEPA in developing systems and processes relating to administration of LBTT and Scottish LfT respectively. The budget was drawn up in summer 2012 in consultation with HMRC and in the light of cost estimates provided to SPICe and reflects the best information then available on likely costs in 2013-14. HMRC have provided an updated estimate for 2013-14 costs of £1.5m across the three HMRC led projects. Provision for

costs falling in 2014-15 and beyond will be dealt with through the Scottish Government's budgeting process at the appropriate time.

26. A Memorandum of Understanding has been agreed between the Scottish Government and HMRC setting out arrangements for overseeing the necessary work on developing and operating SRIT. The MoU is published at http://www.scotland.gov.uk/Resource/0041/00417598.pdf. The Public Audit Committee and the Finance Committee of the Scottish Parliament reviewed the MoU in draft last year. In November 2012, the PAC took evidence on the draft Memorandum from the Comptroller and Auditor General and from the Second Permanent Secretary at HMRC who has been appointed Additional Accounting Officer (AAO) in respect of SRIT. The AAO has agreed to be available to give evidence when requested by the Scottish Parliament and its Committees. However he does not have a formal, statutory duty to give evidence. The PAC also took evidence from Scottish Government officials and from Audit Scotland.

27. A number of important issues relating to establishing and running SRIT were discussed by the PAC with witnesses. These included arrangements for obtaining assurance on value for money; arrangements for external audit and reporting; and the provision of performance information on the operation of SRIT including on tax collected, compliance, and service to taxpayers. Both the PAC and the Finance Committee provided comments on the draft Memorandum, and these were taken into account in agreeing the MoU, which will be kept under review as the SRIT project progresses.

28. The PAC and the Finance Committee have made clear that they wish to continue to monitor progress with establishing SRIT, including by taking evidence from witnesses from the Scottish and UK Governments. The PAC has also made clear that it will seek further comments from the National Audit Office and from Audit Scotland on audit and assurance issues. The Scottish Government is ready to provide whatever further information is requested by the Committee.

Block Grant Adjustments

29. The Command Paper "Strengthening Scotland's Future" sets out arrangements for reducing Scotland's block grant to compensate for the fact that, under the Scotland Act, receipts from devolved taxes (with effect from April 2015) and from SRIT (on present plans, from April 2016) will be added to the Scottish budget. Calculation of the Scottish budget is an administrative matter overseen by HM Treasury. Therefore the block grant adjustment arrangements are not set out in the Scotland Act. However these arrangements are important in determining Scotland's aggregate budget.

30. The block grant adjustments can be considered in two parts – the adjustment in respect of SRIT; and the adjustment in respect of the devolved taxes. As regards the adjustment in respect of SRIT, the UK Government originally described an approach in the Command Paper which caused concern to the Scottish Government. This was because of the effect that the approach would have had on the Scottish budget since 1999 had it been applied during these years. Following a discussion among Ministers at a meeting of the Joint Exchequer Committee and thereafter, it was agreed that an adjusted approach should be used. The approach (referred to as the "Holtham method") was confirmed in the exchange of letters between Scottish and UK Ministers on 20 and 21 March 2012. Officials are working on the details, including data sources. On present plans, the adjustment in respect of SRIT would be made first in 2016-17. For the first two or three years, the adjustment will be notional – the net effect of levying SRIT at 10p in the pound and deducting the block grant adjustment will be zero.

31. Turning to the block grant adjustment in respect of the devolved taxes, the Command Paper notes that "When the smaller taxes are devolved, currently planned to be April 2015, there will be a one-off reduction which will then be deducted from the block grant for all future years."

32. The Office of Budget Responsibility has estimated that in 2011-12, SDLT raised approximately £275m in Scotland and Landfill tax about £100m. The block grant adjustment will compensate for the financial effects of these tax revenues flowing directly to the Scottish Government following planned devolution of the two taxes. The calculation of this initial adjustment remains under discussion.