1 Introduction

1.1 This is a joint response by the Chartered Institute of Taxation (CIOT) and the Low Incomes Tax Reform Group (LITRG) to the Finance Committee of the Scottish Parliament’s call for evidence, as part of the inquiry into Scotland’s Fiscal Framework.

1.2 The CIOT is an educational charity concerned with promoting the education and study of the administration and practice of taxation. For more details see the statement about us at section 14 below. The LITRG is an initiative of the CIOT, which aims to improve the tax system, including tax credits and benefits, for the unrepresented taxpayer.

1.3 Both the CIOT and the LITRG would like to assist in ensuring that the tax system in Scotland is effective and efficient for taxpayers, agents and the tax authorities. We also wish to assist in ensuring that the tax system interacts well with the tax credits and benefits systems.

2 General principles

2.1 The Scottish Government has committed itself to a tax system that has regard to Adam Smith’s four principles: certainty; the burden proportionate to the ability to pay; convenience; efficiency of collection. The CIOT and LITRG agree that these are important principles for a sound tax system. In view of this, we think it is key that due regard is given to them in developing a fiscal framework for Scotland.

2.2 It is essential that a revised fiscal framework for Scotland is consistent with the overall UK fiscal framework. It should be noted, though, that the UK fiscal framework itself is not unalterable, and indeed may be subject to amendment by an
incoming UK Government, particularly in respect of certain elements, such as the fiscal rules.  

2.3 The UK Government highlights two key elements for a fiscal framework at paragraph 2.2.4 of the Command Paper: fiscal rules and fiscal institutions. We think that these could be usefully added to, by taking into consideration various sources.

2.4 For example, as part of the Europe 2020 Strategy, the European Commission has produced a thematic summary that provides a brief overview of the key elements of a robust fiscal framework. The key elements specified are: sound fiscal statistics; numerical fiscal rules; medium-term budgetary frameworks; budgetary procedures; and fiscal institutions. Since there will need to be negotiations and agreements between the UK and Scottish Governments (and possibly between the Scottish Government and European Commission), the first of these elements, sound fiscal statistics, that are independently verified, will be essential as a foundation for any fiscal framework.

2.5 In addition, we think it would be sensible to consider the paper produced by the Fiscal Commission Working Group, which focused on the design of an appropriate fiscal framework for an independent Scotland. The report contains useful ideas, which would also be appropriate in the current context. For example, it stresses the need for independent monitoring, provided by a fiscal institution, in addition to fiscal rules. The inclusion of such additional elements should assist in the development of a robust fiscal framework for Scotland.

2.6 Many of the key areas of concern are referred to in the recent SPICe Briefing, in particular in the sections on the fiscal framework and intergovernmental working.

3 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?

3.1 The UK Government sets out its views on the elements that should comprise a revised funding model for Scotland in the Command Paper. It has been decided that the Barnett formula should be retained as part of the revised funding framework. There are concerns that, the current treatment of Business Rates by

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8 The Barnett formula determines broadly how the block grant changes from year to year – the aim of the formula is to provide the same pound-per-person change in funding for the devolved governments as the change in funding for comparable services in England.
the Barnett formula for Scotland and Northern Ireland is flawed, and could be reformed to better meet the stated policy aims.\(^9\)

3.2 The use of formulae, like the Barnett formula, should assist in ensuring a funding model is more mechanical. In order to ensure fairness, transparency and effectiveness it will be necessary to review the formulae and other methods adopted on a regular (perhaps annual) basis. Reports should be published on how the funding model is operating; these should include any trends or changes that develop. It would be preferable for there to be an independent process of review and for the reports to be scrutinised at parliamentary level – both in the UK and Scotland.

3.3 Taxes and tax revenues will also be an element of the revised funding framework. In order for there to be fairness, transparency and effectiveness the components need to be clearly understood. Since the extent of devolution and treatment of the various ‘Scottish taxes’ varies, their impact on the Barnett formula may differ.

3.4 The requirements of fairness and effective mechanical measures demand the significant use of data, analysis and statistics. Transparency may be reduced, however, by the use of detailed analytics and complex arithmetical adjustments. There will need to be a balance or compromise to resolve the tension between these objectives.

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

4.1 There is an agreed overriding principle that the Scottish Government should bear the risks and reap the rewards of its policy decisions. To do this, the fiscal rules need to assist the objectives of fiscal responsibility and sustainability.

4.2 When considering what fiscal rules might be appropriate, it might be worth examining the Green Budget 2011 of the Institute of Fiscal Studies.\(^10\)

4.3 It is important that the rules do not just contain short-term targets for debt and borrowing; they should contain medium-term and perhaps long-term targets too. When making borrowing forecasts, the costs of borrowing should be factored in.

4.4 Thought should be given as to the purpose of the rules, whether their effectiveness can be measured, and whether the data required to apply the rules is readily available.

5 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?

5.1 The Barnett formula will be adjusted in respect of Land and Buildings Transaction Tax, Scottish Landfill Tax and the Scottish Rate of Income Tax. It has already been

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\(^9\) [http://www ifs org uk/publications/7442](http://www ifs org uk/publications/7442)

adjusted in respect of Council Tax and Business Rates. It may not be appropriate to rely on adjustments to the Barnett formula in some cases.\(^{11}\)

5.2 Most taxes are not hypothecated for a particular purpose. In view of this, a devolved tax should not generally be treated as funding a specific UK government department, in respect of the Barnett formula.

5.3 The way in which the block grant is calculated will affect the budgetary risks facing both UK and Scottish Governments. In order to ensure transparency, the method of adjustment should ensure that Scotland faces the consequences of its policy decisions (positive and negative). There are suggestions this may be difficult to achieve with the Barnett formula. A potential solution has been suggested – that is to treat devolved taxes as ‘comparable’, in the same way that devolved spending is considered ‘comparable’. Two possible methods have been suggested, each having different implications for Scotland: \(^{12}\) indexed deduction and levels deduction.\(^{13}\)

6 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?

6.1 It is generally agreed that the first year adjustments to the block grant are relatively straightforward to implement, although the calculations involved may be complex.\(^{14}\) The block grant is reduced by the amount of revenue being transferred, in respect of a devolved tax. In respect of a devolved spending power, the block grant is increased by the amount the UK would have spent in Scotland on that area.

6.2 The adjustments for subsequent years are more difficult to determine. It is unlikely that the same method of adjusting the block grant will be appropriate for each area of tax or spending. Equally, it is likely that the adjustment cannot simply remain fixed, due to factors including inflation and economic growth.

6.3 It might be possible to index the block grant adjustments according to what happens to the equivalent tax or spending area in the rest of the UK. This would retain the incentive for the Scottish Government to grow tax revenues and limit spend in Scotland, while benefitting from the UK’s protection. The argument against this is that the tax / spend areas in Scotland and the rest of the UK might diverge for reasons unrelated to Scotland’s policies. It would be complex to separate out the effects of Scottish Government policies, in order for Scotland to only bear the risks related to them.

6.4 Whatever mechanisms are chosen, it is essential that there is full agreement from the UK and Scottish Governments, that the data required is available or can be

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\(^{11}\) For example, the welfare spend that is to be devolved does not appear within the Departmental Expenditure Limits that apply to the Barnett formula; instead, welfare benefits belong to Annually Managed Expenditure at a UK level.


\(^{13}\) The indexed deduction method has been proposed in respect of the Scottish rate of Income Tax.

\(^{14}\) Blog post on the Centre on Constitutional Change by David Phillips: [http://www.futureukandscotland.ac.uk/blog/smith-commission%E2%80%99s-proposals-%E2%80%93-big-issues-remain-be-resolved](http://www.futureukandscotland.ac.uk/blog/smith-commission%E2%80%99s-proposals-%E2%80%93-big-issues-remain-be-resolved)
calculated and that there is an agreed method of determining the tax revenues foregone.

7 What mechanisms are required to ensure the effective working of the ‘no detriment’ principle?

7.1 The idea of the ‘no detriment’ principle is sensible. In theory, each government should bear the risks and reap the benefits of their policies. The difficulty arises in practice, when considering how to implement the principle.

7.2 A particular difficulty arises at the outset, in that there is a lack of consensus regarding what might be detrimental and need to be taken into account. Before deciding upon the mechanisms, therefore, there needs to be agreement as to what constitutes ‘no detriment’.

7.3 There are likely to be practical difficulties in untangling the effects of policy decisions on the tax revenues or spending power of the other government. Even if the effects are identifiable, it will be difficult to calculate the amounts involved – there are likely to be numerous possible methods. It may therefore not be practical to provide compensating transfers in many cases, particularly if the effects of the policy in question are conflicting. These practical difficulties are likely to mean that it will be difficult to establish mechanisms and systems capable of dealing with and implementing the ‘no detriment’ principle. A lack of systems and mechanisms means that it is less likely to be transparent, and it is likely to be difficult to determine whether the principle is operating effectively.

7.4 It has been suggested that the ‘no detriment’ principle could be viewed more widely, and encompass tax competition, using the example of Air Passenger Duty. If that is the case, ensuring the effective working of the ‘no detriment’ principle could prove especially problematic.

8 What additional borrowing powers for current spending and for capital spending should the Scottish Government have?

8.1 Since it is likely that the Scottish Government will face additional economic risks due to the devolution of further tax and spending powers, we agree that it should have additional borrowing powers. We agree that these should cover both current spending, so that the Scottish Government can safeguard public spending, for example, and also capital spending.

8.2 Depending on the funding model, it is likely that Scotland will be insulated from UK-wide risks; the Scottish Government should only have responsibility for Scotland-specific risks in devolved areas. The borrowing powers should reflect the risks that the Scottish Government will face.

9 What fiscal rules should be applied to these additional borrowing powers?

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15 Blog post on the Centre on Constitutional Change by Michael Keating: http://www.futureukandscotland.ac.uk/blog/what-detriment
9.1 In terms of borrowing powers to cover current spending, we would expect fiscal rules to require repayment of borrowings according to defined criteria. This would be with the aim of ensuring that the debt does not endure longer than appropriate, or incur higher borrowing charges than necessary.

9.2 In respect of borrowing powers for capital spending, we would expect fiscal rules to reflect the longer-term nature of the investment being made. The fiscal rules should also aim to take account of the cost of borrowing.

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

10.1 We believe it is essential that there are strong inter-governmental relations, encompassing tax, tax credits and welfare benefits – otherwise there is a danger that there will be a lack of coherency in the tax, tax credits and welfare benefits systems for individuals. In order for devolution to be effective for all citizens of the UK, and to ensure effective joint-working on various issues, from fiscal policy to the more detailed activities of budgeting, forecasting, and monitoring, strong inter-governmental relations are key.

10.2 While we recognise that there are already good working relationships between Revenue Scotland and HM Revenue & Customs, for example, we think it would be helpful for there to be a more systematic approach to inter-governmental relations – at various levels, including ministerial and departmental. This should encompass Wales and Northern Ireland too. By way of example, this could take the form of a pan-UK body or a separate devolved administrations liaison group.

10.3 As representative bodies, we note that there are various inquiries and consultations, by different committees of the UK and Scottish Parliaments and different departments of the respective governments. Inevitably, there are questions of interest to all these bodies. We note however, that there is possibly a significant amount of overlap. Often the same representative bodies and stakeholders will be involved, many of which have limited resources. We recommend greater co-ordination in respect of consultations and inquiries – this would be of assistance to stakeholders and would probably result in more effective consultation.

10.4 The Memorandum of Understanding underpinning the current arrangements for inter-governmental working sets out key principles: communication and consultation; co-operation; exchange of information; and confidentiality. In order for the effective devolution of tax and welfare, it is essential that these principles are adhered to. As a memorandum of understanding, the arrangement does not have legally binding force. It might be helpful to place inter-governmental relations on a statutory basis, in order to assist transparency and effectiveness. Transparency would be further improved if briefing notes of inter-governmental (at various levels) meetings were published on government websites, such as GOV.UK and gov.scot – this could include pre-meeting notes requesting input and post-meeting briefings.

16 Memorandum of Understanding and Supplementary Agreements between the United Kingdom Government, the Scottish Ministers, the Welsh Ministers, and the Northern Ireland Executive Committee – October 2013: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/316157/MoU_between_the_UK_and_the_Devolved_Administrations.pdf

17 We note that brief communiques are published on GOV.UK of meetings of the Joint Ministerial Committee: https://www.gov.uk/government/news/joint-ministerial-committee-communique-december-2014
10.5 In order to ensure transparency, it is important that there is proper consultation, subject to our comments at paragraph 10.3 above. This means that consultations should be public and they should be accessible by a broad range of stakeholders. The norm should be to allow a reasonable period for consultation to take place, for example 12 weeks. Sometimes it will be appropriate simply to publish documents for comments; other consultations will require meetings with stakeholders.

11 What mechanisms should there be for reviewing the Statement of Funding Policy?

11.1 We note that the purpose of the Statement of Funding Policy is to set out policies and procedures underpinning the exercise of setting budgets of devolved administrations; it is also intended to provide information on how the funding process operates.\(^\text{18}\)

11.2 We think it would be appropriate for the Statement of Funding Policy to be reviewed at parliamentary level, by both the UK and the Scottish Parliaments. This could perhaps be devolved to a parliamentary committee. Reviews should occur on a regular (perhaps annual) basis.\(^\text{19}\) In addition, if significant change occurs within the UK that might be relevant (such as the devolution of further taxes or spending responsibilities), we would expect this to trigger a review.

11.3 We also think that views should be taken from third parties, for example economists, who might be able to provide useful insight.

12 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?

12.1 We believe that independent scrutiny is an essential element in a robust fiscal framework. With that in mind, we agree that the Scottish Fiscal Commission should be enhanced, to enable it to fulfil this role. In particular, it is essential that there are reliable and timely forecasts of tax revenues – and that there is an independent body capable of providing robust scrutiny. There may also be a role for the Scottish Fiscal Commission in scrutinising new policy proposals in tax and welfare for consistency in interactions with existing rules and proposed new ones.

12.2 We think that the OECD recommendations in respect of principles for independent fiscal institutions could usefully be considered.\(^\text{20}\) In addition, some of our comments regarding a framework for auditing the Scottish Rate of Income Tax may be pertinent.\(^\text{21}\)

\(^\text{18}\) The current Statement is available on the national archives website: http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/sr2010_fundingpolicy.pdf

\(^\text{19}\) We note that the current edition of the Statement was published in October 2010 – it is not clear whether or not it has been reviewed since then.


12.3 We do not have a specific recommendation in relation to who should be responsible for generating forecasts. We think it is important that reports and forecasts provide appropriate assurances to the Scottish and UK Governments; forecasts therefore need to be properly and independently scrutinised. Proper accruals basis accounting should be adopted, such that losses and uncollectable items are taken into account. It is also important that trends and changes from year to year are included.

12.4 At present, there is no alignment between UK-wide forecasts and Scottish forecasts. The result is that in a UK context, the Office for Budget Responsibility has to make its own estimates of Scottish outcomes – this creates challenges and increases the uncertainty of the forecasts. To resolve these issues, we recommend alignment between forecasting for Scotland and the UK as a whole.

12.5 The Scottish Fiscal Commission should have to publish reports, via the Scottish Parliament.

13 What lessons can we learn from the experience of other fiscal federations?

13.1 Once the Smith Agreement has been implemented, Scotland will have control of approximately 60% of its spending and 40% of its tax revenues; these proportions are significantly higher than the OECD average for sub-central governments of 30% and 20% respectively.

13.2 In addition to considering other fiscal federations, lessons can be learned from the relationship between the Barnett formula and business rates.

13.3 Other federal countries make use of fiscal constraints to control fiscal policy. There may be useful lessons to take away from a recent publication concerning fiscal integration of the European Union, which studied a sample of 13 federal countries.

13.4 There may be lessons to learn about borrowing powers – for example, whether it would be advantageous for the Scottish Government to be able to borrow from the market (rather than through the UK Government). This might have implications for the relative costs of debt for each Government, depending on the market perception of the relationship between the UK Government and Scottish Government – for example, would the UK Government step in to assist the Scottish Government if it got into difficulty?

13.5 Another lesson might be concerning inter-governmental relationships and effective joint-working. There are no doubt pointers as to mechanisms that facilitate joint-working in other fiscal federations.

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24 Business as usual? The Barnett formula, business rates and further tax devolution – David Phillips, Institute for Fiscal Studies, IFS Briefing Note BN155 (November 2014)
14 The Chartered Institute of Taxation

14.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT’s work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

14.2 The CIOT draws on our members’ experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT’s comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

14.3 CIOT members are not economists.

14.4 The CIOT’s 17,000 members have the practising title of ‘Chartered Tax Adviser’ and the designatory letters ‘CTA’, to represent the leading tax qualification.

The Chartered Institute of Taxation
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