FINANCE COMMITTEE

INQUIRY INTO THE DEVOLUTION OF FURTHER FISCAL POWERS

SUBMISSION FROM CONFEDERATION OF BRITISH INDUSTRY’S

The CBI is the UK’s leading business organisation, speaking for some 190,000 businesses operating across the UK. With offices across the country as well as representation in Brussels, Washington, Beijing and Delhi, the CBI communicates the British business voice around the world.

CBI members directly employ at least 500,000 people in Scotland, representing a quarter of the private sector workforce. This includes companies headquartered in Scotland as well as those based in other parts of the UK that have operations and employ people in Scotland. We welcome the opportunity to provide input to this inquiry.

This submission builds on our input to the Commission led by Lord Smith of Kelvin on further devolution as a whole, but will focus specifically on tax and fiscal devolution. In particular, it argues that:

1. The UK single market underpins our economic success and a key pillar of this market is keeping business taxes reserved
2. The CBI takes a principled and evidence-based approach to all forms of devolution, including tax and fiscal devolution
3. In the event of further devolution, Scottish institutions and UK-wide institutions must continue to work closely together in order to tackle the deficit, to avoid duplication of approach, and to provide coherent policymaking for businesses.

The UK single market underpins our economic success and a key pillar of this market is keeping business taxes reserved.

1. CBI members in Scotland greatly value the single market that exists in the UK. It is this ease of doing business across the nations of England, Scotland, Wales and Northern Ireland which has helped the Scottish economy to flourish. Scottish businesses rely heavily on seamless trade with the rest of the United Kingdom with 65% of Scotland’s exports going to the rest of the UK.¹ Similarly, a highly mobile and flexible labour market allows working age people to cross the border with ease, with 33,000 working age people moving from rUK to Scotland in 2011 and another 35,000 moving in the opposite direction.²

2. For the UK’s single market to continue to facilitate growth in Scotland, the CBI supports the continued reservation of business taxes – chiefly, Corporation Tax.

A single UK-wide rate of Corporation Tax allows a range of firms to do business with each other throughout the United Kingdom without cost and complexity

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¹ According to the Scottish Government’s 2013 Global Connections Survey
² General Register Office for Scotland, Migration between Scotland and the Rest of the UK, May 2013
3. The CBI is firmly of the view that keeping Corporation Tax reserved provides the simplest environment for UK and foreign businesses to operate in: firms make one clear payment to HMRC reflecting their pan-UK operations.

4. In principle and in isolation, a lower rate of Corporation Tax in a region or nation can yield economic benefits through attracting FDI. But, crucially, this assumes that the region or nation is not part of a broader economic unit in which other regions and nations can respond competitively to attract highly mobile income. This situation would then result in significant costs for governments and businesses alike.

5. The current UK Government’s Corporation Tax roadmap will result in the UK having the lowest headline Corporation Tax rate in the G20 from April 2015, which has sent a positive message abroad that the UK is ‘open for business’. This is particularly important when firms in Scotland and the rest of the UK are increasingly competing in the global economy, not just with firms based elsewhere in the UK. Jeopardising this progress through introducing the complexity of a multiple rate Corporation Tax regime would therefore send an unhelpful signal abroad and lead to increased costs for businesses and a number of distortions.

6. Devolving Corporation Tax would increase the cost of doing business with subsidiaries across the United Kingdom since firms with cross-border operations would be effectively operating in an international regime, with the added complexity that this brings. These include, for example, the potential for a different interpretation of international standards in Scotland (e.g. transfer pricing or the settling of disputes) which will add unnecessary cost and complexity for cross-border firms who are currently used to complying with one regime.

7. Furthermore, the devolution of Corporation Tax may present opportunities for base erosion and profit shifting between the devolved nations, which would have a downward impact on receipts not just in Scotland but also in the UK as a whole. It would run contrary to the objectives of the OECD BEPS (Base Erosion Profit Shifting) negotiations on international tax arrangements, to which the UK Government is committed. There would also be concerns over what the devolution of Corporation Tax – or more specifically a lower rate of Corporation Tax in Scotland – would mean for existing critical incentives such as the R&D Tax Credit, the Patent Box and Capital Allowances.

8. Ultimately, such changes would introduce complexity for the tax authorities in monitoring the location of economic activity. Businesses with cross-border operations are currently subject to a simple UK-wide payment of Corporation Tax, reflecting the common UK tax base. HMRC would have to navigate carefully (and presumably at considerable expense) to work out where economic activity is properly located and what should be taxed in each devolved nation. This process would not be simple, and would penalise growing firms in particular who already lack the resources for tax administration.

9. CBI research shows that nearly half of the UK’s growing medium-sized firms think that the tax system slows down commercial decisions for their business at the expense of

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3 HM Treasury, for example, in Scotland Analysis: Fiscal policy and sustainability, modelled that a 3 per cent reduction in the rate of Corporation Tax in an independent Scotland would increase real Scottish GDP by 0.6 to 0.8 per cent after 20 years. But this assumed no competitive response from the rest of the UK.
planning for future expansion – introducing cross-border taxation for business taxes will only complicate this picture further.\(^4\)

Reserved National Insurance Contributions provide the broad shoulders to support the UK’s social security and pensions system

10. CBI members support the continued reservation of National Insurance Contributions (NICs) due, in part, to the complexity which would result for firms having to comply with diverging rates Employer National Insurance Contributions across the United Kingdom. But, more fundamental is the need to keep National Insurance Contributions reserved because of their connection to the common UK-wide social security and pensions regimes.

11. The National Insurance Fund, for example, is a resource of significant size with an estimated income of around £84 billion from across the UK in 2012/13.\(^5\) This is a collective resource which transcends the interests of a single nation, since it is used to support individuals regardless of location in the UK, and to qualify citizens for a number of UK-wide benefits, including the single tier state pension.

12. Moreover, the devolution of National Insurance Contributions would also have consequences for the pensions tax system. Over the last decade, relief to encourage pensions saving through income tax and National Insurance Contributions has totalled £358.6 billion (excluding tax foregone on the tax-exempt 25% lump sum).\(^6\) Any devolution of National Insurance Contributions would therefore not only impinge on qualification for the UK-wide single tier state pension, but also risk removing Scottish taxpayers from significant and sizeable support for pensions in general through the UK-wide tax system.

The CBI takes a principled and evidence-based approach to all forms of devolution, including tax and fiscal devolution.

13. In consultation with our members in all devolved nations, the CBI has developed a set of principles which can be used across the UK to help assess further devolution proposals and the potential UK-wide impact. We believe that taking a principled and evidence-based approach will help to marry the political drive for an ambitious settlement with the pressing need to support jobs, growth and investment in the Scottish economy together with the rest of the United Kingdom. The CBI’s principles for assessing further devolution proposals are as follows:

- The devolution of power to the nations must have a positive impact on regional growth and competitiveness. Making an evidenced-based assessment on each proposed power will enable us to determine whether or not devolving a particular power would have a positive impact on growth in Scotland.
- Given the utmost importance of the UK single market, a key test must be whether or not devolving a particular power would add undue complexity and compliance problems for business. We also urge the Commission to consider if

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\(^4\) CBI, *Stuck in the Middle: Addressing the tax burden for medium-sized businesses*, June 2014


\(^6\) Between 2002 and 2012, as found in Centre for Policy Studies, *Costly and ineffective: why pensions tax relief should be reformed*, November 2012
a particular power would create a barrier to doing business through the internal market, or if it would **strengthen the internal market**.

- Our third principle takes into **consideration the impact on the wider UK economy**. We must consider the impact, both positive and negative, that devolving a particular power to one nation would have on other nations and the UK economy as a whole. To promote growth in all areas of the United Kingdom, this impact must be shown to not be too disproportionate on other nations and regions.

- Similarly we should assess the **potential for precedent setting** to other nations and regions. We should ask if devolving a particular power to one nation or region will set a model for the same power to be devolved to other nations and regions and assess if this is a positive or negative precedent.

14. Proposals to devolve tax and fiscal powers should be assessed according to the same criteria, prompting some specific questions. Would the devolution of a particular tax distort the UK-wide tax base in any way? Is the base particularly mobile – as is the case for Corporation Tax – or is a Scottish tax base clearly identifiable? Would devolving a particular tax lead to high levels of complexity and compliance which might, actually, in some cases encourage arbitrage and avoidance? What would be the impact of devolving particular features of a tax, e.g. allowances on the Scottish Exchequer?

15. Finally, if the goal of devolving a particular tax is to maximise the revenues it raises for regional or national authorities to spend, one concern might be that this could be at the expense of legitimate reform of the tax in question. This is because tax devolution leads to a situation where devolved authorities are reliant on tax receipts which may be subject to variation, rather than a stable and fixed transfer through the block grant from HM Treasury.

16. Using some of these considerations, we have analysed whether particular taxes would be good candidates for devolution and further issues which will require clarity before businesses can be sure of an evidence-based case.

**Devolving income tax – politicians must be clear on the desired outcome**

17. The further devolution of income tax on earned income could help to narrow the ‘fiscal gap’ between what the Scottish Government spends and collects in taxation, building on current approaches, such as the Scottish Variable Rate.

18. But there are a number of precautions where clarity will be absolutely essential for employers and employees alike if this is to be seen as an example of further devolution working in the best interests of Scotland as part of the wider United Kingdom.

19. Firstly, politicians must be clear that devolution must only apply to income tax on earned income, in order to avoid complex and differing regimes for savings and investment across the UK. There is also the risk that devolving Capital Gains Tax would lead to consumers having to navigate a complex picture of different rates for different assets across the UK. Secondly, devolving rates would largely be a continuation of the current approach in the Scotland Act 2012 and also in Wales with the possible introduction of a Welsh Variable Rate. Thirdly, devolving reliefs would have implications for UK-wide incentives, such as pensions tax relief, if these then have to be applied to different rates of income tax across the UK. Fourthly, devolving
bands could lead to a situation where you have different groups of people caught by different tax nets in different parts of the UK which could lead to complexity. Fifthly, devolving control over allowances to Scotland – if, for example, Scottish Government wanted to replicate the UK Government’s policy on raising the personal allowance threshold for income tax, this would be expensive and would have to be funded by the Scottish Exchequer with a corresponding drop in the block grant. Finally, there would be significant implications for PAYE and self-assessment where arrangements are already in place for charitable giving, trusts, and occupational pension schemes.

20. These are complex issues which must be clearly thought through and explained in any proposals for further devolution in this area. Furthermore, should income tax rates on earned income be devolved, the Scottish Government would have to ensure that marginal rates in Scotland do not negatively impact on talent retention and attraction.

21. If Air Passenger Duty (APD) were to be devolved to Scotland, this would have a direct impact on other regions of the United Kingdom, chiefly the North East of England. At root, APD is a distortive tax which deters the creation of new routes with emerging markets and the related support which these provide for exports. But devolution would set a clear precedent for variable rates of APD across the UK and therefore create competitiveness issues in the English regions, including the need to bid for complex subsidies from airlines in order to keep passenger fares at similar levels in regional airports.

22. The ultimate focus for politicians should not be to create an inefficient bidding war in subsidies between regions, but rather the ongoing reform of APD to ensure that the creation of new routes and the maintenance of existing ones from all parts of the United Kingdom are not deterred through this internationally uncompetitive tax.

23. On VAT, rates must remain reserved in accordance with EU law, which the business community would support, but politicians must show how any devolution of VAT revenues to Scotland will not place additional complexity on businesses as significant collectors of this indirect tax.

24. The CBI is aware that many parties have plans to assign Scottish VAT receipts to Scotland, but more detail is required on several aspects here. Firstly, HMRC and Revenue Scotland would need to work out which transactions are chargeable just in Scotland, as distinct from the rest of the UK, which would be no simple task – specifically, they would need to isolate the ‘value added’ in particular parts of the supply chain in the UK to determine which tax receipts should be allocated where. Furthermore, this task would be much harder to carry out when dealing with intangible rather than purely physical goods. Secondly, if Revenue Scotland were responsible for collecting VAT receipts directly, there could be a cross-over with existing arrangements for passing on taxes to HMRC centrally, particularly if this required businesses to make separate tax returns for separate payments. In this case, it would make more sense for HMRC to hand VAT receipts over after the event in order to avoid businesses having to set up new arrangements for tracking where goods and services have been sold.

Devolving Air Passenger Duty would distort competition with other areas of the UK, underlining why UK-wide reform must remain the goal

Staying within the letter of EU law on VAT without creating complexity for businesses
In the event of further devolution, Scottish institutions and UK-wide institutions must continue to work closely together in order to tackle the deficit, to avoid duplication of approach, and to provide coherent policymaking for businesses.

25. The Scottish and UK economies have been impacted by the political and economic uncertainty created by the Scottish independence referendum as many businesses paused their investment plans. While it is important to ensure a rigorous consultation period, we welcome the ambitious timeframes for delivery of further devolution to Scotland set out by the political parties, as long as they secure a lasting settlement.

26. Ultimately, the business community wants to see a long-term settlement which can provide political and economic security and certainty to support businesses looking to invest. Part of this settlement must involve constructive working between the Scottish Government and UK Government together with all other institutions. For example, the Scottish Fiscal Commission and the Office for Budget Responsibility on monitoring ongoing commitments to fiscal consolidation. Likewise, Revenue Scotland and HMRC must ensure that tax policymaking is joined-up and coherent for businesses who operate in Scotland and across the UK.

We need close co-ordination between the Scottish Fiscal Commission and the Office for Budget Responsibility to hold all Governments to account for fiscal discipline

27. The CBI expects the UK Government to borrow £98.3 billion in 2014/15, showing that the UK still has a long way to go in eradicating its underlying deficit. The decisions which devolved governments and local authorities – as well as central government – take will therefore be critical if the UK is to see the fiscal consolidation plan completed. The state of the public finances will have to be carefully scrutinised by independent fiscal committees to look at the impacts of policy changes at both a Scottish and UK-wide level. In practice, this will mean close interaction between the Scottish Fiscal Commission and the Office for Budget Responsibility on those policies which, for example, relate to a reserved area but will have an impact on Scottish Government finances. Similarly, decisions on tax and spending in Scotland will have implications for Scotland’s fiscal position which in turn will impact upon the UK as a whole.

28. The ongoing need to reduce Public Sector Net Borrowing across the UK as a whole is reflected in the debate over borrowing powers and limits for national and local administrations. Borrowing for capital investment is an area where, to a certain extent, London has been leading the way in the UK with devolved powers that allowed, for example, the issuing of a bond to finance Crossrail in 2011. The CBI supports the Scottish Government’s innovative use of Tax Increment Financing as a form of revenue retention to stimulate investment in infrastructure.

29. However, on the enhanced borrowing powers contained in Scotland Act 2012, businesses need to see the impact of these powers before taking a wider view on the mechanisms for borrowing and to see how the markets will respond. This is particularly the case for the Scottish Government’s new power to raise so-called ‘tartan bonds’ directly from the markets, without any credit history and as a new borrower.

Revenue Scotland must work with HMRC to ensure that tax policymaking is joined-up and coherent for businesses who operate in Scotland and across the UK.
30. The CBI has previously set out a range of tax policymaking principles which we would expect devolved authorities to adhere to in collaboration with central government. This is absolutely critical if we are to ensure that devolution does not jeopardise further progress in the UK towards developing a competitive tax environment which provides stability and certainty for businesses. The CBI’s UK-wide tax policymaking principles are as follows.

31. **First, tax policymaking must be transparent and predictable.** In the current economic climate it is important that tax policy supports rather than inhibits economic growth. Sudden and unexpected changes harm both businesses and the Exchequer, and should be avoided unless there are exceptional reasons for immediate intervention. It is important that stakeholders have early warning of policy changes. There needs to be a transparent, methodical process for changing tax laws in a way that engages all stakeholders, minimises surprises and ensures legislation is stress-tested before becoming law. In the majority of cases there is no need for budget secrecy. When it comes to tax policy, openness should become the default position of tax authorities.

32. **Second, tax authorities must continually improve the consultation process with businesses.** The government should talk to key stakeholders before it publishes consultation documents to establish whether there is a real need for policy change or consultation. Governments must also take steps to further improve their consultation exercises. Options could include deploying web-based consultation tools with the appropriate controls and differentiation for key stakeholders, as the European Commission does, or carry out a greater number of informal consultations.

33. **Third, there must be more effective interaction between tax policymakers.** Interaction at a UK-wide level between HM Treasury, HMRC and the Parliamentary Counsel continues to cause difficulties. This has led to problems in moving from policy conception to well-drafted legislation during the drafting stage. This happened with the new Controlled Foreign Companies regime where the proposed new rules resulted in extremely complex draft legislation despite an effective and productive consultation. It is also a recurring annual problem with the time-restricted Finance Bill process. The quality of legislative drafting needs to be improved to ensure that onerous legislation does not undermine policy development. Scottish policymakers would have to show how tax collection by Revenue Scotland would not further complicate this process.

34. **Fourth, strengthen the independent review of tax law.** It is important to have an independent process for reviewing the effectiveness of tax laws. The formation of the Office for Tax Simplification (‘OTS’) has been a welcome step in the UK, but if the OTS is to be effective it needs to be properly funded. Furthermore, the OTS should be given the power to comment on whether proposed legislation meets its policy objectives.

35. **Fifth, improve economic analysis capacity and capabilities.** The Corporate Tax Roadmap recognised the benefits of having stable business taxation and the most competitive corporate tax regime in the G20. However, more needs to be done to strengthen HM Treasury and HMRC’s tax economics expertise and increase the use of dynamic effects of tax rates on tax revenues. Full dynamic tax analysis – which forecasts the effects of businesses’ reactions to incentives created by policy – will strengthen the evidence base in supporting a move towards a more economically efficient tax system. When comprehensive dynamic analysis has taken place, for
example with HMRC’s 2012 analysis of the top rate of personal income tax, the analysis highlighted the mistaken assumption that higher tax rates automatically raise significantly more revenue. Full dynamic analysis needs to be introduced for all major taxes to make an accurate trade-off between the need to raise tax revenue and the potential cost in economic activity foregone as a result of higher tax rates.