Finance Committee

8th Report, 2013 (Session 4)

Report on implementation of the financial powers in the Scotland Act 2012

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Finance Committee

Remit and membership

Remit:

1. The remit of the Finance Committee is to consider and report on-

(a) any report or other document laid before the Parliament by members of the Scottish Executive containing proposals for, or budgets of, public expenditure or proposals for the making of a tax-varying resolution, taking into account any report or recommendations concerning such documents made to them by any other committee with power to consider such documents or any part of them;

(b) any report made by a committee setting out proposals concerning public expenditure;

(c) Budget Bills; and

(d) any other matter relating to or affecting the expenditure of the Scottish Administration or other expenditure payable out of the Scottish Consolidated Fund.

2. The Committee may also consider and, where it sees fit, report to the Parliament on the timetable for the Stages of Budget Bills and on the handling of financial business.

3. In these Rules, "public expenditure" means expenditure of the Scottish Administration, other expenditure payable out of the Scottish Consolidated Fund and any other expenditure met out of taxes, charges and other public revenue.

*(Standing Orders of the Scottish Parliament, Rule 6.6)*

Membership:

Gavin Brown
Malcolm Chisholm
Kenneth Gibson (Convener)
Jamie Hepburn
John Mason (Deputy Convener)
Michael McMahon
Jean Urquhart

Committee Clerking Team:

Clerk to the Committee
Jim Johnston

Senior Assistant Clerk
Catherine Fergusson

Assistant Clerk
Alan Hunter

Committee Assistant
Parminder Kaur
INTRODUCTION

1. The aim of this report is to provide the views of the Finance Committee on the implementation to date of the financial powers within the Scotland Act 2012 ("the Act") including the adjustments to the block grant.

2. The Committee has carried out a number of strands of work relating to the implementation of the financial powers within the Act. The Committee has just published its Stage 1 report on the Landfill Tax (Scotland) Bill and was lead committee in scrutinising the passage of the Land and Buildings Transaction Tax (LBTT) Bill. The Committee also expects to be lead committee on the Revenue Scotland and Tax Powers Bill which is due to be introduced in the Autumn.

3. The Committee has also agreed to take evidence on an annual basis from both HMRC officials and the Office for Budget Responsibility (OBR). The Committee also heard from Professor Gerald Holtham who was chair of the Independent Commission for Funding and Finance for Wales and from members of the David Hume Institute in a round table format.

4. Finally, the Committee took evidence from both the UK Government and the Scottish Government on their respective first annual reports on the implementation and operation of the financial powers within the Act. The Committee wishes to thank all those witnesses who have supported its work in this area.

5. This report will firstly consider the implementation of the Scottish Rate of Income Tax. It will then examine the implementation of the LBTT and Landfill Tax and, finally, the new borrowing powers.

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*1 UK Government First annual report on the implementation of the financial provisions of the Scotland Act 2012; Scottish Government First Annual Report on the implementation and operation of Part 3 (Financial Provisions) of the Scotland Act 2012*
SCOTTISH RATE OF INCOME TAX (SRIT)

6. The UK Government’s white paper, *Strengthening Scotland’s Future*, proposes that SRIT will be introduced in April 2016. Section 26 of the Act provides for the basic rate, higher rate and additional rate of the non-savings income of a Scottish taxpayer to be reduced by 10%. The Scottish Parliament will then levy a new SRIT which will apply equally to all of these rates. This power will supersede the existing tax varying power, the Scottish variable rate (SVR).

7. The new Scottish Rate will need to be set annually by the Scottish Parliament. The Act requires that a **Scottish rate resolution** “must be made before the start of the tax year” and that the “Standing Orders must provide that only a member of the Scottish Government may move a motion for a Scottish rate resolution.” However, the white paper states that in order to allow HMRC to process the necessary administrative and compliance measures the Scottish rate “will need to be formally communicated to the UK Government by the end of December in the preceding calendar year.”

8. The Committee is mindful that there will need to be a number of changes to the Parliament’s Standing Orders and the Written Agreement on the budget process. In particular, there is a need to ensure that the parliamentary procedure for scrutinising the new financial powers is joined up with the existing budget process. Scottish Government and Scottish Parliament officials are currently examining options for the necessary changes for consideration by Ministers and the Committee.

**Transitional Period**

9. Following the devolution of SRIT there will be a transitional period which is expected to be around 2 or 3 fiscal years during which the deduction in the block grant arising from the 10p reduction will be calculated annually. During this period the deduction in the size of the block grant will be based on the OBR forecast of Scottish income tax receipts for the forthcoming fiscal year. The command paper states that “these will not be reconciled during transition and the UK Government will bear the risk of any deviation of outturn from the forecast.”

10. On the basis that SRIT is introduced in April 2016 then the Scottish Government’s Draft Budget for 2016-17 which is due to be published in September 2015 will need to include a proposed Scottish rate including the forecast receipts. At present the OBR produces its economic and fiscal outlook at the time of the UK budget in March which means that the forecast for Scottish taxes published in March 2015 would be the most recent available figures to inform the draft budget.

11. However, the next UK election is due in May 2015 and there is a possibility that the new Government would hold a fresh budget and could alter income tax rates and thresholds which may have an impact on the income tax forecast for 2016-17.

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2 *HM Government. Strengthening Scotland’s Future.*
3 *HM Government. Strengthening Scotland’s Future.*
and beyond. This raises the question of the timing and the data used by the OBR in carrying out its Scottish tax forecasts to inform the Scottish draft budget.

12. At the same time the Committee notes that the Scottish Government states in its implementation report that “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.” This means that during the transition period a shortfall in income tax receipts would not result in a reduction to the Scottish budget. The Cabinet Secretary for Finance, Employment and Sustainable Growth (the Cabinet Secretary) explained that—

“Essentially a prediction will be made and agreed, and that will be honoured by the UK Government. Once the financial year is complete and all the data is available, the data will validate whether the prediction was correct. However, nothing will happen as a consequence of that, as that is the nature of the transition period.”

13. However, it is not clear what the effect will be if the parliament agrees to a SRIT either above or below 10p in the pound. For example, if the parliament agrees to a rate of 11p and the forecast was pessimistic. Given that there is no reconciliation between the forecast and the actual receipts, the Committee is unclear as to why the Scottish budget would not be disadvantaged if the actual receipts for the 11p rate were higher than the forecast.

14. The Chief Secretary to the Treasury (CST) stated in response to questioning on this point that “during the transition period, the UK Government bears the risks of deviation from the forecast.”

15. The Committee invites the Scottish Government to clarify the process for publishing its annual proposal for SRIT including the forecast receipts.

16. The Committee notes that the UK Treasury will bear the risk of any deviation from the forecast but is unclear how this will work in practice given that there will not be any reconciliation between the outturn receipts and the forecast during the transition period.

17. The Committee invites the Scottish Government to clarify how this will work in practice including where, for example, the Scottish Parliament decides to change the 10p rate either upwards or downwards during the transition period.

18. The Committee notes that there is a lack of clarity in relation to the timing and data to be used by the OBR in carrying out its forecast for SRIT to inform Draft Budget 2016-17 and beyond. The Committee invites the Scottish Government to explain in detail how this will work in practice including the impact of the UK general election in May 2015.

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4  http://www.scotland.gov.uk/Publications/2013/04/5026
### Forecasting and Reconciling SRIT

19. The OBR began providing forecasts of various Scottish tax receipts alongside its *Economic and fiscal outlook* (EFO) for the UK economy and the public finances in March 2012. The OBR will continue to publish its forecast for these taxes alongside each EFO which is published at the time of the UK budget and each Autumn. As with the OBR’s main UK forecasts these are five-year forecasts.

20. The OBR produced a methodology note in March 2012 setting out how it plans to forecast Scottish tax receipts. It stated “The OBR’s role in forecasting is starting three years ahead of the initial devolution of the taxes, which will allow us to develop and improve forecasts in the light of experience and the availability of new information sources.” In evidence to the Finance Committee on 28 March 2012 the chairman of the OBR stated that “we very much view the forecasts as work in progress for the time being. This is a learning experience, for us and for everybody.”

21. The OBR has now published three Scottish tax forecasts. The figures for SRIT are as follows—

#### OBR SRIT forecasts (£m)

<table>
<thead>
<tr>
<th>Year</th>
<th>Mar-12</th>
<th>Dec-12</th>
<th>Mar-13</th>
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<tbody>
<tr>
<td>2011-2012</td>
<td>4,375</td>
<td>4,480</td>
<td>4,330</td>
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<tr>
<td>2012-2013</td>
<td>4,417</td>
<td>4,462</td>
<td>4,240</td>
</tr>
<tr>
<td>2013-2014</td>
<td>4,542</td>
<td>4,472</td>
<td>4,246</td>
</tr>
<tr>
<td>2014-2015</td>
<td>4,874</td>
<td>4,602</td>
<td>4,332</td>
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<tr>
<td>2015-2016</td>
<td>5,265</td>
<td>4,918</td>
<td>4,649</td>
</tr>
<tr>
<td>2016-2017</td>
<td>5,633</td>
<td>5,242</td>
<td>4,976</td>
</tr>
</tbody>
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22. The OBR stated that the downward change in the forecast tax receipts for March 2013 compared with the December 2012 forecast reflects the “deterioration in the UK forecast and the Budget 2013 policy announcement that the personal allowances will reach £10,000 in 2014-15.” However, it went on to state that it “still expect(ed) growth in receipts to pick up from 2014-15 onwards” on the basis of “stronger growth in average earnings and rises in employment as the economy improves.”

23. The Committee notes that there has been a significant reduction in the forecast from March 2012 to March 2013. For example, the forecast for 2014-15 has been reduced from £4874m to £4332m which is a reduction of £542m.

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7 *OBR, Economic and fiscal outlook: Scottish tax forecast, March 2013.*
8 *OBR, Economic and fiscal outlook: Scottish tax forecast, March 2012.*
24. The OBR is not able to directly replicate the methodology they use to produce the UK forecasts and Scottish forecasts are instead based on “Scotland’s historic share of the relevant UK tax stream.” This means that “the Scottish tax forecast is derived by applying the Scottish share to our projection of the UK tax base.” The Scottish share of income tax is currently based on an annual HMRC Survey of Personal Incomes (SPI). However, this is only available with a long lag, with the 2010-11 data published in December 2012.

25. The OBR forecasts the Scottish share of income tax in March 2013 as follows—

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</tr>
</thead>
<tbody>
<tr>
<td>March</td>
<td>3.16%</td>
<td>3.15%</td>
<td>3.03%</td>
<td>3.01%</td>
<td>2.87%</td>
<td>2.89%</td>
<td>2.88%</td>
<td>2.88%</td>
<td>2.88%</td>
</tr>
</tbody>
</table>

26. HMRC is in the process of identifying Scottish taxpayers and will flag them appropriately on its PAYE and SA systems. HMRC will apply a Scottish tax code (S codes) to all Scottish tax payers within PAYE and their employers prior to the introduction of SRIT. The SA system will also be adapted so that Scottish taxpayers within SA will declare their status as part of their annual return. HMRC confirmed in a letter to the Public Audit Committee (PAC) that—

“HMRC systems will be designed to identify the revenue from the Scottish rate, which will be paid to the Scottish Government to fund its expenditure, and identified separately in the HMRC annual Trust Statement.”

27. Following the transition period the outturn receipts for SRIT will be reconciled with the OBR forecast with a corresponding transfer either to or from the Scottish budget to the UK consolidated fund. The white paper states that the reconciliation will occur no later than 12 months after the end of the financial year when it is expected that 99.3% of income tax will normally have been collected. No further reconciliation will be made.

28. When the outturn is above forecast the Scottish Government will be able to retain this surplus in a new Scottish cash reserve which can be used to offset any years in which the outturn is below the forecast. If there is no cash reserve and the deviation is more than 0.5% of the Scottish resource budget then the parliament will be able to borrow to cover the shortfall over a period of up to 4 years.

29. Audit Scotland stated in a written submission to the Committee that “it is important that the Scottish Government and the OBR can show that the forecasts are soundly based and that the reasons for any variances between actual and estimated tax receipts are made clear.”

30. The Cabinet Secretary stated in oral evidence to the Committee on 1 May 2013 that—

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11 Audit Scotland. Written Submission.
“As a consequence of the land and buildings transactions tax, the landfill tax and the Scottish rate of income tax, we will acquire a set of revenue-raising responsibilities. My view is that Scotland will require an independent forecasting body that can provide independent assessment to the Government and the Parliament of what might be generated as a consequence of those taxes. I am considering how that should be established.”

31. The Committee is currently carrying out an inquiry into the role and remit of the new body and written submissions are available at: [http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/67138.aspx](http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/67138.aspx)

32. The Committee notes that the forecasting and reconciliation of Scottish tax receipts will become integral to the annual budget process. The Committee emphasises that it is essential that the methodology and the data used to calculate these forecasts and reconciliation is published, transparent and open to scrutiny. The Committee also agrees with Audit Scotland that the reasons for any variances between the forecast and actual tax receipts are made clear.

33. The Committee will report separately on its views on the proposed independent forecasting unit for Scotland but emphasises the need for transparency in demonstrating that its forecasts are soundly based as noted by Audit Scotland. The Committee invites the Scottish Government to provide an update on the timing for the establishment of the independent forecasting body and asks whether it is anticipated that it will have a role in forecasting SRIT receipts.

34. The Committee notes that the white paper states that the reconciliation will occur when “nearly all of the outturn receipts are known and no later than 12 months after the end of the financial year.” The Committee invites the Scottish Government to provide further details regarding how the reconciliation will work in practice including how and when the decision will be made that “nearly all of the outturn receipts are known” and whether an estimate will be made of the remaining receipts.

35. The Committee notes that HMRC currently provides an estimate of SRIT outturn receipts based on the annual SPI. The Committee intends to write to the OBR inviting it to provide the reasons for any variation between this estimate of outturn receipts and its own forecast when publishing its Scottish tax forecasts and then between its forecast and the outturn receipts for SRIT once they become available.

36. The Committee will also question the Chairman of the OBR on the Scottish tax forecasts when he appears before the Committee on an annual basis.

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37. The Committee recommends that the Scottish Government provides the Scottish Parliament with an annual report on the outturn figures for SRIT including details of the reconciliation process and the reasons for any variance between the forecast and outturn.

SRIT Payments

38. Income tax receipts can vary quite considerably from one month to the next and will also vary annually. A proportion of income tax is also not received by HMRC until well into the following tax year. The white paper states that—

“In order to protect the funding for public services in Scotland from these effects, the UK Government will make payments, when they are required, to the Scottish budget corresponding to a forecast of Scottish income tax receipts.”13

39. This means that the Scottish Government will receive payments when they are needed rather than when actual tax revenues are received. Furthermore, and in order to protect the Scottish budget “from unexpected economic shocks” the payments will be based on the forecast which is available at the start of the Spending Review period. Any variation between the forecast and the outturn receipts could be addressed in the annual budget if required.

40. The Committee notes that this means that the SRIT payments which the Scottish Government receives will be based on the OBR forecasts which may be made more than a year before the start of the first year of the Spending Review period. This raises questions about the accuracy of the OBR forecasts over a number of years.

41. Professor David Bell produced a paper for the Scotland Bill Committee on forecasting income tax receipts in which he noted that although Treasury forecasts tended to be optimistic the amount involved was small.14 For example, between 1999-2000 and 2009-10, the average year-ahead forecast exceeded the average outturn by £1.7 billion out of an average of total revenues worth £125 billion which is less than a 1% variation.

42. However, Professor Bell also pointed out that some of these forecasts are made just a few months before the start of the fiscal year and can, therefore, make use of the most up-to-date data. He went on to state that “increasing the forecast horizon also causes the average error (the measure of over-optimism) to rise dramatically.” For the period 2004-05 to 2009-10, the average error for forecasts made from two years before the start of the fiscal year increased to £8.4 billion and from three years before the start to £10.9 billion. He stated that “whether the OBR will improve on HMT methodology and be more cautious in its forecasts of income tax revenue remains to be seen.”

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13 HM Government, Strengthening Scotland’s Future, Page 27
14 Prof. David Bell: The Scotland Bill Proposals for Forecasting and Reconciling Income Tax Receipts
43. The Scotland Bill Committee also noted that HM Treasury forecasts for income tax also tended to be over-optimistic and that the largest errors occurred during the recent recession. It recommended that the £500m borrowing limit is at least doubled.\(^{15}\)

44. The Committee notes that the size of the Scottish budget at the start of each Spending Review period will be in part dependent on the OBR forecast for SRIT. This means that forecasting errors could have a significant impact on the Scottish budget. In particular, the Committee notes that these errors have tended to be on the optimistic side and have tended to increase as the length of the forecast horizon increases.

45. The Committee is, therefore, concerned about the proposal to make SRIT payments on the basis of OBR forecasts at the start of a Spending Review period. The Committee invites the Scottish Government to respond to the concern that income tax forecasts have tended to be overly optimistic and the longer the forecast period the likelihood that forecast errors will be greater and, therefore, the greater the possible impact on the Scottish budget following reconciliation.

**Implementation of SRIT**

46. The UK Government’s implementation report states that the implementation of SRIT is being led by an HMRC project with oversight being provided by “representatives from HMRC, HM Treasury and the Scotland Office as well as the Scottish Government”. The project is responsible for 3 main areas relating to the implementation of SRIT—

- Identifying Scottish taxpayers;
- Enabling the administration and collection of SRIT from April 2016;
- Developing a transparent and efficient process to account for the collection of SRIT.

47. The report states that during 2013-14 “the project will design new processes which will ensure that HMRC can accurately and efficiently collect” SRIT. The report also states that work on the necessary IT systems changes will begin in 2014 and take around 2 years.

**Identifying Scottish taxpayers**

48. The UK Government implementation report states that HMRC will “develop an approach to identifying Scottish taxpayers, based on an examination of current HMRC data on taxpayers’ places of residence and potential additional sources of information.” HMRC expects to make potential Scottish taxpayers aware during 2015-16.

49. HMRC advised the Committee during oral evidence that it is examining its existing data to establish the extent to which it can provide information on Scottish residency. HMRC will—

“then need to design a process for contacting people, how they could dispute a ruling from us about whether they were within the Scottish rate and what sort of checks we might want to do against external sources to try to check when people were not necessarily giving us the right answer.”

Implementation Costs

50. The UK Government implementation report states that the cost of the project is estimated at between £40-45m for implementation including around £10m in IT costs and £4.2m annual running costs thereafter. HMRC officials stated in evidence to the Committee in May 2012 that this was an estimate when the bill was published and that “we hope that expenditure will be significantly less than £45 million.”

When pressed as to whether this remained the case, HMRC officials confirmed at the Committee’s meeting on 8 May 2013, that “I certainly hope that it will be.”

51. However, the Scottish Government implementation report states that 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.” The Cabinet Secretary stated in evidence to the Committee on 1 May that “Demonstrating value for money remains essential in terms of the cost of implementation.”

52. The UK Government implementation report states that the costs for the Scottish Government for 2012-13 are £165,141 and estimated costs for 2013-14 are £1.5m. The latter costs include work in relation to switching off SDLT and landfill tax as well as the implementation of SRIT. The Scottish Government has paid the invoice for 2012-13 and has paid a further invoice for £196,870 to cover costs in respect of SRIT for the first quarter of the 2013-14 financial year.

53. Draft Budget 2014-15 includes the following allocation for Scotland Act Implementation—

<table>
<thead>
<tr>
<th></th>
<th>2013-14</th>
<th>2014-15</th>
<th>2015-16</th>
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<tbody>
<tr>
<td></td>
<td>£3.5m</td>
<td>£10m</td>
<td>£40m</td>
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54. The draft budget states that these funds are for “implementation of the financial provisions in the Scotland Act 2012.”

55. The Committee asks the SG to provide further details of the funding which has been allocated in Draft Budget 2014-15 for the implementation of the Scotland Act 2012.

56. The Committee will continue to take evidence on the implementation of SRIT from HMRC officials on an annual basis and will also monitor the implementation costs as part of its budget scrutiny.

20 Scottish Government Draft Budget 2014-15
Adjustment of the Block Grant - SRIT

57. The UK Government and the Scottish Government have agreed through the Joint Exchequer Committee (JEC) a number of principles for the adjustment of the block grant. The JEC has agreed to apply an “overarching objective of fairness” by—

- minimising the risk of gains/losses from funding transfers on both the UK and Scottish Governments;
- ensuring that the mechanism is not, when implemented, designed to gain advantage in one set of fiscal circumstances or another;
- considering the effects of a shared tax base (including issues related to policy spillover and tax avoidance).

58. The two governments have also identified several technical issues to work through including—

- Ensuring that the measure of indexation is based on transparent data;
- The use of forecasts and reconciliation with outturn receipts;
- Ensuring that the adjustment is transparent;
- Selection and preparation of estimates of tax base movements in advance of actual information being available;
- The thresholds and treatment of spill-over effects caused by UK income tax policy decisions;
- The number of annual adjustments.

59. Following the transition period there will be a reduction to the block grant for SRIT which will then be recalculated each year using the “Holtham Method” as discussed below. The UK Government’s white paper states that the “policy decision on which methodology to use for this calculation is fundamental to the future success of the new financing arrangements.” While the white paper does not recommend how the reduction should be calculated it does state that it “would be a percentage based on the average worth of the devolved tax receipts over a number of years, not a single year.” The white paper goes on to point out that the outturn receipts from the Scottish income tax during the transition period would, therefore, “be instrumental in informing the reduction in the block grant.”

60. It is not clear from the evidence which the Committee has received whether any progress has been made in agreeing the methodology to calculate the reduction in the block grant arising from SRIT. Indeed, there is no mention of it in either of the implementation reports from the two governments.

61. It also not clear what data will be used to inform the reduction in the block grant. For example, given the lag in calculating total outturn receipts for SRIT, it is unlikely that there will be sufficient data collected during the transition period to

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provide “an average worth of the devolved tax receipts over a number of years” as recommended in the white paper.

62. In contrast the Cabinet Secretary has stated clearly in relation to the devolution of land tax that the reduction should be based on a five-year average of receipts preceding the implementation of LBTT.

**Indexation**

63. The UK Government and the Scottish Government have agreed to adopt the “Holtham Method” for indexing the block grant adjustment in relation to SRIT. In correspondence between the governments it has been agreed that this “approach to indexing would recalculate the block grant adjustment year by year by indexing it to movements in the Non savings Non Dividend income tax base in the rest of the UK.” This means that—

“The net effect on the Scottish block as a result of adding receipts from the Scottish rate and subtracting the block grant adjustment will therefore depend on the growth in the Scottish rate tax base in Scotland (reflected in the growth in receipts) relative to growth in the Non Savings Non Dividend income tax base in the rest of the UK (reflected in the indexing of the block grant adjustment). There is no dependency on movements in public spending.”

64. The FSU has provided a table (which can be found at Annexe A) which shows the available outturn movements in the UK and Scottish tax bases since 1999-00. This shows that aside from two years (2000-01 and 2004-05), the Scottish income tax based has matched or outgrown the UK’s. Data for 2008-09 is not available.

65. The Cabinet Secretary notes that “the Holtham methodology links the Scottish tax base with the performance of the Scottish economy, which is a welcome and appropriate connection” and that there “is therefore an inherent incentive for the Scottish Government to ensure that our economic policies and interventions are designed to expand the tax base of Scotland.”

66. Professor Holtham stated in his written submission that “using the UK tax base as the index means domestic policies are not offset but if the UK government alters the tax base it will compensate the effect in the deduction from the block grant.” While he believes that this works well for income tax “it does not work well where there are reasons to think that the UK tax base will grow at a very different rate from that of the devolved territory.” He argues that it “is not in the devolved territory’s interest if its own tax base is inevitably slower growing than that of the UK.”

67. The Committee’s previous Budget Adviser identified a number of risks for the Scottish Government as a consequence of the ID method—

- **Cyclical risk** – the risk should be relatively small;
- **UK policy risk** – the risk to Scottish Government revenues is small;

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23 Letter from Secretary of State for Scotland to Cabinet Secretary for Parliamentary Business, 20 March, 2012.
• **Scottish Policy risk** – the Scottish Government bears the risk of how its own policies impact on the Scottish income tax base;

• **Asymmetric growth** – this occurs if the Scottish economy grows more rapidly or more slowly than the UK and is intended to encourage growth-enhancing policies.

68. However, the Cabinet Secretary stated to the Committee that the Holtham method provides “the basis for achieving a fair block grant adjustment in relation to” SRIT.  

**Extraneous risks**

69. The Committee also considered the impact of changes to the income tax base due to extraneous risks which are not related to government policy. It may be the case that the income tax base in Scotland grows more slowly than the income tax base in the UK as a whole but for reasons which the Scottish Government has no means of influencing. For example, if the population in other parts of the UK was to grow more quickly than in Scotland then this may result in an increase in the size of the UK income tax base. In response to questioning from the Committee on this issue Professor Holtham stated that he had assumed that the same adjustment in relation to relative population changes which applies to the Barnett formula would also apply to the block grant adjustment.  

70. Professor Holtham pointed out that while there is no obvious means of avoiding extraneous risks there is nevertheless a potential difficulty in allowing a divergence between the two tax bases as a consequence of these risks. He, therefore, suggests that the block grant should be revisited around every 15 years to assess any cumulative divergence and if that has occurred then the block grant should be recalibrated. However, he admitted that it would not be possible after 15 years to separate the impact of extraneous factors from government actions. But without the option to recalibrate you may “get a cumulative divergence in which one part of the country becomes increasingly less favoured or more favoured than other parts.” He argues that the recalibration should be based on a “needs adjustment” which accounts for factors such as poverty, demographics and geography.

71. The white paper states that following the permanent reduction the UK Government will continue reviewing the system—

“to ensure that the relative levels of public expenditure going forward remain consistent with what the Commission described as the social and economic unions between Scotland and the rest of the United Kingdom. This approach is intended to serve as a safeguard to both the Scottish and UK Parliaments once the new arrangements are implemented, for example by limiting the risk of an unintended transfer of resources one way or the other.”

72. The principles agreed by the JEC include a commitment to reviewing the adjustment of the block grant “to ensure that the system remains fair and fit for

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purpose." However, Professor Bell points out that “we do not know what that may mean.” He also suggests that it is not clear how the principles of transparency and fairness that underlie the JEC principles “would be applied if a large divergence took place.”

73. The Cabinet Secretary pointed out that the block grant is an administrative system rather than statutory and, therefore, there is the possibility that “the block grant could be adjusted at some later stage.”

74. The Scottish Government has stated in correspondence with the UK Government that “we will seek the 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 subsequently confirmed that “such funding arrangements would include arrangements for the block grant adjustment.”

75. The Committee welcomes the commitment by the Scottish Government to seek the agreement of the Parliament to the adjustments to the block grant. The Committee emphasises that it is essential that the methodology and data for calculating the adjustment to the block grant for SRIT and the devolved taxes is published in detail and is open to scrutiny.

76. The Committee recognises that there is a considerable amount of work involved for the two governments in agreeing proposals for the adjustment of the block grant. However, the Committee is concerned about the lack of detail which has been made available. The Scotland Bill Committee expressed similar concerns in its report on the Bill in December 2011 and nearly two years later, there remains a considerable lack of transparency in relation to the adjustment of the block grant.

77. The Committee welcomes the use of the Holtham Method for indexing the adjustment of the block grant. However, the Committee notes that it remains unclear how the initial reduction will be calculated and invites the Scottish Government to provide an update on progress in agreeing the methodology to be used.

78. The Committee asks whether the indexing of the block grant adjustment will take into account relative changes in population size.

79. The Committee notes that there is also a real lack of transparency in relation to the basis for reviewing the adjustment of the block grant.

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Letter from Cabinet Secretary for Parliamentary Business to Secretary of State for Scotland, 21 March 2012.

Scottish Government response to Finance Committee’s Stage 1 Report on Land and Buildings Transaction Tax Bill.

particular, it is unclear what would happen if a significant cumulative divergence takes place.

80. The Committee will ask both the Scottish Government and the UK Government to provide more detail on the timing and criteria for reviewing the adjustment of the block grant and to confirm that the Scottish Parliament will be consulted in carrying out any review.

LAND AND BUILDINGS TRANSACTION TAX (LBTT)

81. The Committee published its Stage 1 report on the general principles of the LBTT Bill on 27 March 2013. The Committee concluded that it supported the general principles of the Bill and emphasised that it would aim to closely monitor the implementation and delivery of LBTT. The Bill then proceeded through Stages 2 and 3 of the legislative process and received royal assent on 31 July 2013.

82. The new tax will replace Stamp Duty Land Tax (SDLT) on 1 April 2015. The Act “makes provision for a tax which should be as simple as possible to understand and pay and which will place the minimum administrative burden on the taxpayer or their agent and on the tax authority.” The Scottish Government also intends to replace the current “slab” structure with a “proportional progressive structure.”

Forecasting SDLT/LBTT receipts

83. The OBR forecasts SDLT receipts for Scotland on the basis of “a constant share of overall UK SDLT receipts.” For residential SDLT the OBR uses the latest outturn figures and project this forwards. So, for example, in the March 2013 forecast the OBR use a figure of 3.7% for residential SDLT which is consistent with the 2011-12 outturn figures. For commercial SDLT the OBR uses a three year average of the Scottish figure and project this forwards. The Scottish share of UK SDLT receipts is based on actual outturns from HMRC data.

84. The OBR forecasts which have been published to date for SDLT are as follows—

OBR Stamp duty land tax forecasts (£m)

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85. The Committee heard evidence during its Stage 1 inquiry on the LBTT Bill that the OBR forecasts were “wildly optimistic”.\textsuperscript{37} The Committee also notes that the OBR forecast in March 2012 for Scottish SDLT receipts for 2011-12 was £319m which was £44m higher than the actual receipts of £275m. The OBR forecast in March 2013 of £323m was £40m higher than the actual receipts of £283m.

86. The Committee notes that both of these forecasts were overly optimistic despite being calculated towards the end of the financial year to which they refer when much of the outturn data would presumably have been available.

87. The OBR Scottish tax forecasts assume that the current system of SDLT will remain in Scotland after the tax is devolved in April 2015. The OBR stated that—

“Once firm details of the proposed new tax are available, we will generate forecasts for the new tax.”\textsuperscript{38} The Financial Memorandum (FM) for the LBTT Bill stated that the Scottish Government “will propose LBTT rates and bands when bringing forward the draft budget for 2015-16 in autumn 2014.”

88. The Committee notes that the forecasting of LBTT receipts will become an important aspect of the annual budget process. The Committee emphasises that it is essential that the methodology and the data used to calculate these forecasts is published, transparent and open to scrutiny.

89. The Committee will ask the OBR to explain the extent to which its March 2012 and March 2013 forecasts for Scottish SDLT were based on available outturn data.

90. The Cabinet Secretary confirmed during oral evidence that the Scottish Government is conducting its own forecasting for LBTT receipts and the Committee asks that these forecasts and the methodology are published.

91. The Committee notes the intention of the Scottish Government to establish an independent forecasting unit and asks whether this body will be established in time to provide forecasting for LBTT receipts for the 2015-16 budget and, if not, which forecast will be used.

92. The Committee recommends that Revenue Scotland reports to the Parliament on a 6 monthly basis with details of the outturn figures for LBTT.

93. The Committee will ask the OBR to provide details of the methodology it intends to use to forecast LBTT receipts and to provide the reasons for any variation between its forecast for SDLT/LBTT receipts and the outturn figures as they become available.

94. The Committee will also ask the OBR how and when it intends to forecast receipts for LBTT in 2015-16 when no outturn receipts for LBTT will be available.


\textsuperscript{38} OBR, Economic and fiscal outlook. Scottish tax forecast, March 2013.
Block Grant Adjustment - LBTT

95. The white paper states that when Land Tax and Landfill tax are devolved in April 2015 “there will be a one-off reduction which will then be deducted from the block grant for all future years.” The white paper also states that the availability of outturn data for Scottish SDLT receipts means that the calculation of the appropriate reduction in the block grant should be “readily identified”.

96. The Draft Budget 2014-15 states that the indicative figures for 2015-16 are subject to the adjustment of the block grant following the devolution of Land tax and Landfill Tax and that details of “the actual amount of the adjustment are still to be agreed with HM Treasury.”

97. The FM for the LBTT Bill stated that “it is reasonable to assume that receipts from LBTT will be equivalent to those from SDLT at present and that the block grant adjustment will be broadly equal to the level of SDLT receipts.” On this basis the FM states the financial impact of the new tax should be broadly neutral. However, the FM also states that “It is clear that when replacing one tax system with another with a different tax structure, the tax yield will not be exactly the same as previously.”

98. A number of witnesses pointed out to the Committee during its Stage 1 inquiry that while LBTT receipts may be broadly similar to SDLT receipts there is nevertheless a high level of volatility which will have an impact on the Scottish budget.

99. The most recent data for outturn receipts for SDLT in Scotland demonstrates the extent of the volatility as follows—

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<td>320</td>
<td>250</td>
<td>330</td>
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100. The Cabinet Secretary stated in evidence to the Committee on the LBTT Bill—

“Between the March and December forecasts in 2012 that looked forward from 2012-13 onwards, the OBR reduced the estimated tax-take by 9.75 per cent, 11.1 per cent, 13.6 per cent, 13.3 per cent and 13.4 per cent. I put those numbers on the record to make the point that, given that pattern, the forward estimating of SDLT is very difficult.”

101. Given this volatility the Cabinet Secretary stated that “the most reliable way of taking forward the issue is to look at a five-year average in the run-up to the implementation of the devolution of the tax responsibility.” The Committee notes that on this basis the block grant adjustment for LBTT would be based on a five-year average for the period 2010-11 to 2014-15.

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39 Land and Buildings Transaction Tax Bill, Explanatory Notes (and other accompanying documents)
102. However, the UK Government takes a different view. The CST stated in evidence to the Committee that the methodology for calculating the adjustment “needs to take into account not only what has happened recently but the prospects for the taxes” as well. He stated that “given that the recent period has been extraordinary, a calculation based on it would not give a reflection of the prospects for revenues from SDLT that is fair to both Scotland and the United Kingdom.”

The CST suggested that it may be necessary to look at long-term trends and that there may need to be periodic reviews.

103. Draft budget 2015-16 which is due to be published in September 2014 will be the first Scottish budget which will need to include the deduction in the block grant arising from the devolution of land tax and the forecast receipts for LBTT. At that point the latest outturn figures which will be available for SDLT will be for 2012-13. By the time the new tax comes into force in April 2015 the outturn figures for 2013-14 will also be available.

104. The FSU has provided the figures below which gives an illustration of the impact on the size of the block grant adjustment depending on which five–year average is used.

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<td>410</td>
<td>456</td>
<td>509</td>
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105. These figures demonstrate that it is unsurprising that the Scottish Government prefers an adjustment based on a five year average pre-devolution of SDLT while the UK Government favours an adjustment which includes a forecast of receipts post-devolution.

Indexation

106. The Cabinet Secretary pointed out in evidence to the Committee that the Scotland Bill Committee in the previous Parliament “stated that it should be a one-off, non-index linked adjustment to the block grant.” However, the CST stated in evidence to the Committee that “I have real problems with the idea of having a one-off adjustment purely in cash terms. Clearly, with inflation, the value of such a one-off adjustment would erode over time and would therefore cause a windfall gain to the Scottish Government and windfall loss to the UK taxpayers over quite a number of years.”

107. The Cabinet Secretary suggests that “the way to address the issue is to have a discussion and an agreement that relates to all the devolved small taxes, taking into consideration the fact that there is likely to be a loss of revenue on landfill tax, and come to a reasonable position on the totality of block grant adjustment that should be taken into account.”

108. The CST seemed to agree with this approach, stating that “It would be possible to have adjustments differentiated between the two taxes, but it is probably simpler to take the two together because growth or shrinkage in each tax base could be offset by shrinkage or growth in the other.”

109. The Committee asks the Scottish Government whether there has been an agreement with the UK Government to calculate a collective block grant adjustment for both LBTT and Landfill tax which is discussed below.

110. The Committee notes that there would appear to be significant differences between the two governments as to which figures should be used to calculate the block grant adjustment in relation to SDLT.

111. The Committee’s view is that while it is likely that the adjustment will need to be based on a combination of outturn figures and forecasts there is also a need to account for the following issues—

- The evidence which the Committee received during its Stage 1 inquiry on the LBTT Bill stating that the OBR forecasts were “wildly optimistic”;  
- The OBR forecasts in both March 2012 and March 2013 were overly optimistic by £44m and £40m respectively despite being calculated towards the end of the financial year when much of the outturn data would presumably have been available;  
- The five year average based on the latest outturn receipts is £127m lower than a five year average of subsequent OBR forecasts;  
- HM Treasury have been historically over-optimistic when forecasting tax receipts;

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The longer the forecast horizon the greater the measure of over-optimism.

The Committee emphasises that it is essential that the methodology and data for calculating the adjustment to the block grant for SDLT is published in detail and is open to scrutiny.

LANDFILL TAX

The Scottish Government introduced a Landfill Tax Bill on 17 April 2013. The purpose of the Bill is to replace the UK Landfill Tax regime with legislative provisions for a Scottish Landfill Tax that will come into force the day after the UK landfill tax is dis-applied in Scotland. The Committee published its Stage 1 report on 12 September.

Forecasting Landfill Tax Receipts

There are no Scotland-specific figures for landfill tax revenues available from HMRC as revenue receipts are based upon reporting at a company level rather than by landfill site, and many companies operate cross the UK. The OBR forecast Scottish landfill tax receipts by assuming a constant share of UK landfill tax receipts based on an average of the last three years. The first three forecasts are as follows—

OBR Landfill tax forecasts (£m)

<table>
<thead>
<tr>
<th>Year</th>
<th>Mar-12</th>
<th>Dec-12</th>
<th>Mar-13</th>
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<tr>
<td>2011-2012</td>
<td>115</td>
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<td>2012-2013</td>
<td>123</td>
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<td>2014-2015</td>
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<td>105</td>
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<td>2015-2016</td>
<td>151</td>
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<td>2016-2017</td>
<td>157</td>
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<tr>
<td>2016-2017</td>
<td>110</td>
<td>108</td>
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The OBR explain that the significant fall in forecast receipts from March 2012 to December 2012 is primarily due to a weaker UK forecast. However, the Landfill Tax Bill FM states that the OBR “does not take into account Scottish-specific policies that will affect the amount of material going to landfill.”

The Scottish Government stated in its consultation on the Bill that while it is difficult to accurately forecast future revenues from landfill tax in Scotland “it is highly likely the Scottish Government's Zero Waste Plan will see both the quality and type

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48 Landfill Tax (Scotland) Bill
of material landfilled in Scotland change substantially, with far less material going to landfill and what is landfilled being largely inert materials.”

117. The Cabinet Secretary stated in evidence to the Committee on 1 May 2013 “I found the original OBR forecasts on landfill tax to be inexplicable. Any rudimentary assessment of performance in the policy area of waste to landfill in Scotland would identify that the trajectory for landfill tax must be going down...” The FM states that the Scottish Government expects “landfill tonnages in Scotland to significantly decrease over the coming decade with a corresponding reduction in receipts.” The Scottish Government estimate that landfill tax receipts will fall from £107m in 2015-16 to around £40.5m in 2025.

118. The Committee notes that the forecasting of Landfill Tax receipts will become an important aspect of the annual budget process. The Committee emphasises that it is essential that the methodology and the data used to calculate these forecasts is published, transparent and open to scrutiny.

119. The Committee recommends that any forecast for Scottish landfill tax receipts needs to take into account the relevant policies of the Scottish Government.

120. The Committee asks the Scottish Government whether the new independent forecasting body will be established in time to provide forecasting for Landfill Tax receipts for the 2015-16 budget and, if not, which forecast will be used.

**Block Grant Adjustment – Landfill Tax**

121. The Bill Team stated in its Stage 1 evidence to the Committee that broadly speaking “the OBR sees tax revenues from landfill tax staying level in cash terms from 2015 onwards, whereas we project a significant reduction.” On this basis they indicated that the Scottish Government aims “to achieve a block grant adjustment that is as low as possible so that we minimise the risk of the Scottish budget losing when the devolved taxes start up in April 2015.”

122. The Committee also received evidence which suggested that there is no need to index the adjustment to the block grant following the devolution of landfill tax. Professor Holtham suggests that with stable, static taxes with a shrinking base, such as landfill or aggregates it should be possible to agree on a one-off deduction without the need for indexation.

123. However, the CST stated “I do not think that there is a particular divergence in forecast landfill tax revenues between Scotland and the rest of the UK. We would want an adjustment methodology that reflected the facts on both sides.” He pointed out that the revenues from landfill tax will be declining on a UK wide basis.

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50 Scottish Government Consultation on a Scottish Landfill Tax
52 Scottish Parliament, Finance Committee, Official Report, 24 April 2013, OR Col. 2530
53 Scottish Parliament, Finance Committee, Official Report, 4 September 2013, OR Col. 2867
124. **The Committee emphasises that it is essential that the methodology and data for calculating the adjustment to the block grant for Landfill Tax is published in detail and is open to scrutiny.**

**BORROWING**

125. The Scotland Act 2012 provides Scottish Ministers with borrowing powers for three purposes from April 2015—

- up to 10% of the Capital DEL budget for capital spending for each year with a statutory limit of £2.2 billion;
- up to £200m annually and £500m in total to deal with deviations between forecast and actual revenues;
- an appropriate cash working balance to deal with temporary shortfalls between receipts and expenditure.

126. Audit Scotland stated that these “are significant new powers and it will be important that the Scottish Government can demonstrate that investment plans are affordable, prudent and sustainable, and supported by clear borrowing policies and practices.” It went on to state that the Scottish Government “will also need to consider how best to support effective scrutiny of borrowing decisions by ensuring it discloses relevant information in budget documents and its annual accounts.”

127. **The Committee agrees with Audit Scotland that government borrowing should be affordable, prudent and sustainable and that parliamentary procedures are developed to ensure effective scrutiny of the use of the new borrowing powers.**

128. **The Committee notes that the Scottish Government and Parliament officials are considering possible options for the provision of information about borrowing in future draft budgets. The Committee recommends that this should include details of the purpose and rationale for any proposed borrowing.**

**Capital Borrowing**

129. The Scottish Government implementation report states that “HM Treasury have made clear that borrowing in any one year must not exceed 10%” of capital DEL. It can borrow from the National Loans Fund (NLF) and can select the type of loan. It can also borrow by way of a commercial loan from a bank or other lender. The Scottish Government will be expected to provide an estimate of its expected capital borrowing from the NLF before the year in which the borrowing will take place.

130. **The CST stated that “We set out in the spending round that capital borrowing powers in 2015-16 will be £296m.”** The Scottish Government has indicated in its Draft Budget 2014-15 that its indicative spending plans for 2015-16 assume the full £296m of borrowing to support capital investment. The Scottish Government states

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that it will borrow the money from the National Loans Fund (NLF) and that it is assumed that repayment will be over 25 years at an interest rate of 5%.

131. However, the Scottish Government’s implementation report states that the terms of the 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.” The implementation report also states that “interest rates will be those prevailing at the time for NLF borrower. For example, the current NLF interest rate for a 10-year loan repaid through equal instalments of principle is approximately 1.1%.”

132. The UK Government has also consulted on enabling the Scottish Government to issue bonds and states in its implementation report that it “will respond to the consultation in due course”. The Scottish Government states in its implementation report that it “has argued that it should have the power to issue bonds should it choose to do so”.

133. The Committee invites the Scottish Government to clarify why Draft Budget 2014-15 assumes that repayment will be over 25 years at an interest rate of 5%.

Revenue Borrowing

134. The Scottish Government implementation report states that the new revenue borrowing powers are to “help smooth fluctuations in tax receipts” and are to be repaid within 4 years (paragraph 18). Such borrowing will be from the NLF and the terms and conditions will be agreed between Ministers and the NLF.

135. This borrowing will be available in relation to the devolved taxes from 2015-16 and in relation to SRIT following the transition period. However, the Committee has noted that the OBR forecasts for SRIT have already been significantly revised downwards. It was suggested by some witnesses that there may be some questions as to whether the borrowing limit is sufficient to accommodate future forecasting errors.

136. In response to questioning on the accuracy of the OBR forecasts the Cabinet Secretary pointed out that the changes to the forecast for the Scottish rate must take into account the changes to the forecast for the UK as a whole. The CST explained that this means that there would only be an impact on the Scottish budget “if the change in the forecast for Scotland is different from the change in forecast for the rest of the UK.”

137. The Committee is concerned that the Scottish Government may have to borrow money as a consequence of forecasting errors rather than as a consequence of poor economic performance. The Committee asks the Scottish Government whether there has been any discussion with the UK Government regarding the terms and conditions of any loan required as a consequence of forecasting errors.

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56 Scottish Parliament, Finance Committee, Official Report, 4 September 2013, OR Col. 2864
CONCLUSION

138. The Committee recognises that there is a considerable challenge for both the UK Government and the Scottish Government in implementing the financial provisions of the Scotland Act 2012. Nevertheless it is essential that there is effective parliamentary scrutiny of the implementation process. The Committee is concerned about the level of information being provided by the two governments as the negotiations progress. At the same time the Committee welcomes the commitment of the Scottish Government to consult with the Scottish Parliament on the adjustments to the block grant and emphasises the need for sufficient time to be made available to allow the Committee to carry out effective scrutiny of the proposals.
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<td>571.8</td>
<td>585.1</td>
<td>581.0</td>
<td>636.0</td>
<td>693.0</td>
<td>740.0</td>
<td>788.0</td>
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<td>577.2</td>
<td>591.0</td>
<td>587.3</td>
<td>642.4</td>
<td>700.4</td>
<td>747.6</td>
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<td>23.9</td>
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<td>22.4</td>
<td>22.8</td>
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<td>138.7</td>
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<td>143.0</td>
<td>156.0</td>
<td>164.0</td>
<td>173.0</td>
<td>182.0</td>
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<td>330.3</td>
<td>398.0</td>
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<td>426.4</td>
<td>421.9</td>
<td>463.6</td>
<td>510.1</td>
<td>545.8</td>
<td>583.8</td>
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<td>10.0</td>
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<td>15.6</td>
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<td>NSND income tax base = NSND income net of allowances, deductions and reliefs</td>
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<td>39.1</td>
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Source: HMRC, personal correspondence
ANNEXE B: INDEX OF ORAL EVIDENCE SESSIONS

11th Meeting, 2013 (Session 4) Wednesday 17 April 2013
Robert Chote, Chairman, The Office for Budget Responsibility.

12th Meeting, 2013 (Session 4) Wednesday 24 April 2013
Professor Gerald Holtham, Chair, Independent Commission for Funding and Finance for Wales; Jeremy Peat, Director, The David Hume Institute; David Bell, Professor of Economics, University of Stirling; David Ulph, Professor and Head of School of Economics and Finance, St Andrews University; Drew Scott, Professor of European Union Studies, University of Edinburgh; John McLaren, Centre for Public Policy for Regions, University of Glasgow; Ken Gibb, Professor in Housing Economics, University of Glasgow.

13th Meeting, 2013 (Session 4) Wednesday 1 May 2013
John Swinney, Cabinet Secretary for Finance, Employment and Sustainable Growth, Alistair Brown, Deputy Director, Fiscal Responsibility Division, and Jonathan Sewell, Principal Policy Analyst, Scottish Government.

8th Meeting, 2013 (Session 4) Wednesday 8 May 2013
Edward Troup, Second Permanent Secretary, and Sarah Walker, Deputy Director and Head of Devolution Team, HM Revenue and Customs.

20th Meeting, 2013 (Session 4) Wednesday 4 September 2013
Rt. Hon Danny Alexander MP, Chief Secretary to the Treasury, UK Government.
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