I welcomed the publication of the Finance Committee’s report on the implementation of the financial powers in the Scotland Act 2012. The annex to this letter provides the Scottish Government’s response to the Committee’s comments and questions (Annex A). While we continue to believe that the very modest transfer of fiscal powers in the Scotland Act 2012 represents a missed opportunity to deliver real accountability to Scotland through access to wider economic levers, we are fully committed to their successful implementation. The Committee is already aware of this from the first annual report provided by the Scottish Government in April, and from evidence I gave to the Committee in support of the annual report on 1 May last year.

I welcome the Committee’s interest in and its report on these important and complex issues. I believe that the recently-agreed adjustments to the Written Agreement represent a major step forward in terms of providing a structure within which the Committee and the Parliament will be able to scrutinise the implementation and operation of the financial provisions of the Scotland Act 2012. I welcome also the Committee’s scrutiny of our plans and those of the UK Government in relation to the block grant adjustments and other key elements of the financial provisions. I look forward to further discussions about proposals for a Scottish fiscal commission, which will have a key role in providing assurance and in supporting openness and transparency in relation to forecasting of tax receipts and other matters.

I understand and share the Committee’s concern about the lack of agreement on a method for calculating the block grant adjustment in respect of the devolved taxes. I remain committed to consulting the Committee on proposals, and will do so as soon as some progress has been made between HM Treasury and the Scottish Government on this matter.

Finally, I hope that this response to the Committee’s report is helpful, and I look forward to providing the Committee with a further update on these issues in the next statutory implementation report due in April.

JOHN SWINNEY
Annex A


Parliamentary scrutiny and processes

1. The report noted the need for changes to the Written Agreement on the budget process. I am glad that we have been able to agree these, and I welcome the Committee’s publication of the amended Written Agreement. I also welcome your approach to the Convenor of the Standards, Procedures and Public Appointments Committee on this matter. We will, as you have noted, need to consider together in due course whether further adjustments should be made to reflect the introduction of the Scottish rate from April 2016, on present plans.

Transition Period and setting the rate

2. The Committee made a number of observations and raised questions on this topic in paragraphs 15 to 18 of its report. I expect that the arrangements for proposing and setting the rate of SRIT each year will be a matter for agreement between the Finance Committee and the Scottish Government in due course, in the context of reviewing the Written Agreement with respect to SRIT. Were we to agree a process that was similar to that recently finalised for the devolved taxes, that would imply the Scottish Government setting out proposals for the rate of SRIT, together with a forecast of receipts, in the draft Budget document each autumn, beginning in autumn 2015 for 2016-17. These proposals would be scrutinised by the Committee, alongside the Government’s other taxation proposals and its spending plans. In subsequent years, the draft Budget document would include information about forecast outturn and actual receipts. The budget document for 2016-17 and onwards would also provide information about how the SRIT block grant adjustment had been calculated. We also envisage that the draft Budget would provide an independent assessment of tax receipts forecasts.

3. As noted, this outline process would of course be subject to further discussion and agreement between the Finance Committee and the Scottish Government in due course. If the Committee found it helpful, I would be very happy to discuss these issues further now.

4. The Committee sought further information about the risk of deviations between forecast and actual SRIT receipts during the transition period, and the significance of not undertaking reconciliations then. The approach envisaged by the UK Government is that, during the transition period, the block grant adjustment in respect of SRIT will be based on forecast SRIT receipts with the rate set at 10p. At the same time, Scotland’s block grant for the relevant year will have added to it an amount equal to forecast SRIT receipts. In other words, the Scottish budget will be the product of the Barnett-based block grant (as now), less the block grant adjustment, plus forecast SRIT receipts. If the rate is set at 10p, then for each year of the transition period the block grant adjustment and the amount added to the block grant to represent SRIT receipts will be identical, and the Scottish budget will be no better and no worse off. This means that the budget will not benefit from actual receipts being higher than forecast, nor will it be reduced if receipts are lower than forecast. In addition, the full amount of forecast receipts will be paid over in the relevant year. So the Scottish
budget will not gain or lose as a result of timing risks – that is, faster or slower than expected collection of SRIT revenues.

5. The UK Government describes this as “HM Treasury bearing the risk of any deviation from forecast”. The risk of course cuts in both directions, as noted above. Although no formal reconciliation will be carried out during the transition period, there will be information available on actual SRIT receipts, and it will be possible to compare these against the original forecasts.

6. During the transition period, actual SRIT receipts will be accounted for by HMRC, and accounts will be published and audited. The UK Government’s intention is that by comparing actual receipts with forecasts, it will be possible for HMRC and OBR to improve forecasting accuracy so that at the end of the transition period, reasonably reliable forecasts of SRIT receipts will be available. In respect of the first year after the transition period – referred to below as ‘year 1’ - a receipts forecast will be prepared using methods and data that have been refined during the transition period. The block grant adjustment will be set at the same level, assuming that a rate of 10p has been set. Actual SRIT receipts for the year will in due course be accounted for. Once an audited figure is available, this amount will be used to re-set both the year 1 estimated SRIT receipts figure and the block grant adjustment. The net effect on the budget in year 1 will be zero. But the block grant adjustment in year 1 - which forms the starting point for calculating the block grant adjustment in future years under the Holtham mechanism – will be set at the correct base level.

7. For year 2 and thereafter, the block grant adjustment will be calculated by applying the change in the UK non-savings, non-dividend (NSND) tax base in the form of an index number to the block grant adjustment for the previous year. In practice, in year 2 the block grant adjustment for the previous year will be based on a forecast, and the index will be applied to this forecast. The same will apply to the initial block grant adjustment for year 3. Once audited outturn figures are available for year 1, the year 1 forecast will be replaced by actuals and the effect of this will be carried forward to the following years.

8. In addition, at the point of setting the block grant adjustment for year 2, only a forecast of the change in the UK non-savings, non-dividend (NSND) tax base, and therefore of the index number, will be available. Figures enabling calculation of the actual movement in the tax base, from which the final index number will be calculated, will become available at approximately the same time as the actual SRIT receipts figure for year 2. Once the actual data is available to calculate the true index number in respect of year 2, this will be applied to generate the actual block grant adjustment for year 2. The correct block grant adjustment figure will then be applied, as will the correct figure for SRIT receipts, and the Scottish budget recalculated. The difference between the Scottish budget based on forecasts and the Scottish budget based on actuals will be added to (or deducted from) the Scottish budget in the next future year. The size of this difference will depend on the relative forecast error for the UK and Scottish NSND tax bases – in other words, between the error in forecasting SRIT receipts and the error in forecasting the NSND index number to calculate the block grant adjustment. The impact on the Scottish budget will be limited to any SRIT forecast error over and above that for the UK.

9. The process described is complicated by the need to recalculate the Scottish budget once audited outturn figures are available, in place of forecasts. If the complications of substituting actual figures for forecasts are stripped out, the Scottish budget will
depend on the block grant, as it does at present, plus actual SRIT receipts which will depend on the Scottish NSND tax base, minus the block grant adjustment which moves in line with changes in the UK NSND tax base. Therefore the Scottish budget will be better off if the Scottish tax base grows faster than the UK tax base, and worse off if the Scottish tax base grows more slowly. (The Scottish budget would also be increased if the rate was set above 10p and reduced if the rate was set below 10p.) This is how the Holtham methodology is intended to work, and I hope that this explanation helps to demonstrate that it would work as intended.

10. It can therefore be said that after the transition period, the Scottish budget will bear some of the “risk” of fluctuations in receipts – in either direction. However that risk will not crystallise (in the form of adjustments up or down to the block grant) until at least two years after the year in question. The risk of UK-wide fluctuations will remain with the UK Government.

11. The Committee also asked (at paragraph 34) about the timing of the reconciliation process, and at what point an accurate view can be taken of actual receipts for the year. The details are still under discussion with the UK Government. But it seems clear, as indicated above, that reconciliation will depend on the production by HMRC of audited accounts. HMRC indicate that information to support accounts for tax receipts is generally reasonably complete about 12 months after the end of the relevant tax year, and accounts are produced and audited thereafter. To give an example, tax receipts in respect of tax year 2018-19 would be largely gathered in by March 2020, and accounts would be produced and audited by autumn 2020. A reconciliation could then be carried out, and the results reflected in the budget for 2021-22. It is intended that actual SRIT receipts struck at the point when the accounts are drawn up will be adjusted upwards by an estimate of the amount of tax due that remains to be collected. This estimate will be based on evidence from previous collection patterns and rates, and will be included in the accounts for auditing, enabling the auditors to confirm whether the estimate appears to them to be soundly based. The report of the auditors will of course be made to the Scottish Parliament, and HMRC’s Additional Accounting Officer can be asked to give evidence and to answer questions.

12. I should emphasise that the detail of these issues remains under discussion between officials, and that all aspects have not yet been defined and agreed. However I want to give the Committee as clear a picture as possible of the matters under discussion and the conclusions that are emerging.

13. I want to turn now to the Committee’s question about what happens if the Scottish Parliament passes, before 5 April 2016 in respect of 2016-17 (or in respect of a later year within the transition period), a Scottish rate resolution setting a rate different from 10p. In that case, the OBR will adjust its estimate of actual SRIT receipts up or down by reference to the rate set, and the Scottish budget will receive that higher or lower amount as part of the block grant for the year. However the block grant adjustment would continue to be based on a 10p rate. This means that the Scottish budget would see a net increase if a rate higher than 10p was set, and a net reduction if a rate lower than 10p was set. At the same time, HMRC would adjust its income tax administration arrangements so that the correct amount of tax was deducted from Scottish taxpayers’ income. Forecast outturn figures for SRIT would be prepared as described above, and would be used to improve forecasting and estimating. A higher or lower rate of SRIT would not in itself make a difference to the process. However a materially higher or lower rate might have some impact on the tax gap. We would
expect HMRC to monitor any such impact closely, and to include an assessment of compliance work in their SRIT report and accounts.

14. For future years after the transition period, a variation in the Scottish rate upwards or downwards from 10p would be taken into account by OBR in forecasting receipts for the year, and the amount of the forecast would be paid over as part of the Scottish budget during the year in question. In the same way as described above, actual SRIT receipts and the UK NSND tax base would then be reconciled to forecasts based on audited accounts and the Scottish budget would be adjusted if necessary in the first financial year after production of the audited accounts.

15. The Committee also asked about the timing and data to be used by the OBR in preparing forecasts for 2016-17 and beyond. The description above provides as much certainty as we can derive from the UK Government’s description of the intended process. Some details of the timing of final OBR estimates remain to be settled, but we do not expect these to make any material difference to the process or its outcome. However it is important to bear in mind that during the transition period, the block grant adjustment will equal forecast receipts, unless a rate other than 10p is set as explained above. Consequently if during the transition period a forecast turns out to be incorrect because, for example, very recent developments were not factored in, the Scottish budget will not be better or worse off as a result.

16. Following the transition period, the same would apply until the reconciliation process was completed. At that point, the UK Government would make an adjustment to the Scottish budget. After a time lag of 3 years or so, the Scottish budget would benefit if actual growth in the Scottish NSND income tax base had been higher than actual growth in the UK NSND income tax base, and would be reduced if growth had been lower. Effectively, the budget would be adjusted to reflect actuals rather than forecasts – some 3 years after the year in question.

17. I realise that this is a long, detailed and complicated explanation. That reflects the nature of the arrangements that the UK Government is putting in place administratively following the Scotland Act 2012. As noted elsewhere in this letter, all of the details have not yet been settled, but the description provided reflects our current understanding. I hope the Committee finds it useful.

Forecasting and reconciliation

18. The Scottish Government agrees with the Committee that the forecasting and reconciliation of Scottish tax receipts will become integral to the annual budget process. In relation to SRIT, it is important to note (as stated earlier) that after the transition period, forecasts will be reconciled to outturn, so that there should be no net effect on the budget, taking one year with another, as a result of forecast errors.

19. As regards transparency, our intention is that the draft Budget document will, as described above and subject to agreement in due course with the Committee, provide full information about SRIT forecasts (provided by the OBR), about the calculation of the block grant, and about actual receipts. This should assist the Committee and others in scrutinising these key elements that will bear on the Scottish budget. The Committee will – again as noted, and subject to further discussion and adjustment of the Written Agreement – have the opportunity to take evidence on this information and to debate and make recommendations about it.
SRIT Payments

20. The Committee was concerned about SRIT forecasts being made at the beginning of a Spending Review period and covering a period up to 2 or 3 years ahead, with a risk of considerable forecasting error. This is the position set out in the Command Paper. The UK Government took the view that this arrangement would provide some certainty about the size of the Scottish budget during each Spending Review period. However, thinking on this issue has developed since then, largely as a result of the agreement reached on use of the Holtham block grant adjustment mechanism. The current position, from which I hope the Committee will derive some assurance, is that forecasts of SRIT receipts, and the corresponding amount of the block grant adjustment, will be made for each year on the basis of the most recent available data. Once the transition period has concluded, the annual reconciliation between forecasts and actuals is likely to result in adjustments, up or down, to the Scottish budget as explained above. We expect that adjustments flowing from the reconciliation will take effect 3 years after the year in question, giving time for appropriate planning in response. The scale of adjustments is expected to be modest, because the Holtham approach operates in such a way that the Scottish budget is not impacted by unforecasted movements in UK income tax, but only by relative movements in Scottish receipts in relation to UK receipts.

Implementation of SRIT

21. The Committee asked at paragraph 55 for further details of the £10 million allocated in the draft budget for 2014-15 for implementation of the Scotland Act 2012. This total includes provision of approximately £5.5 million for payments to HMRC in respect of implementing SRIT, and approximately £4.5 million to cover the costs of implementing the devolved taxes. This includes estimated costs expected to be incurred by Revenue Scotland, Registers of Scotland, and SEPA in implementing the devolved taxes during the year, as well as payments to HMRC for “switch-off” of Stamp Duty Land Tax in Scotland. A contingency has also been included within the £4.5 million.

22. I welcome the Committee’s commitment to take evidence from HMRC officials on the implementation of SRIT on an annual basis, and to monitor implementation costs as part of its budget scrutiny.

Adjustment of the Block Grant - SRIT

23. I note and agree with the Committee’s comments about the need for the block grant adjustment methodology to be open and transparent. As noted above, and subject to further discussion and agreement with the Committee in due course, I believe that despite its innate complexities the block grant adjustment arrangements, covering both methodology and data, will be opened up to examination through the draft Budget document and the associated scrutiny process.

24. I also note the Committee’s concern about an apparent lack of detail on how the block grant adjustment process will work, and in particular how the initial reduction will be calculated. I hope that the description given above will help the Committee in considering how the block grant adjustment will be set during the transition period. As noted, in that period (assuming a 10p rate) the adjustment will be set at the same level as forecast SRIT receipts, and there will be no reconciliation between forecast and actual receipts. Consequently the amount of the block grant adjustment will not have an impact on the Scottish budget. At the end of the transition period, the block
grant adjustment will be set at the level of expected SRIT receipts in that year. Thereafter, the block grant adjustment for future years will be indexed by reference to year on year movements in the UK’s NSND income tax base. A further adjustment will be made, when the audited outturn SRIT receipts figure becomes available for the base year. At that point, a once and for all correction will be made to the initial block grant adjustment to bring it into line with actual receipts in the base year. This will be carried through to relevant subsequent years. Thereafter, changes to the block grant adjustment will be made on the basis of changes to the UK NSND index as explained above, in the first place on the basis of a forecast, and then adjusted further when actuals are available with the adjustment applied to the Scottish budget in the next future year.

25. The Committee has asked (paragraph 78) about indexation of the non-savings, non-dividend income tax base to relative population size. I have asked officials to give further consideration to this question. As set out in the Command Paper, the details of a no-detriment policy are also under consideration with HMT, although the agreement to index the block grant adjustment to the relevant tax base (the Holtham method) should reduce the need for further adjustments as the method automatically compensates for UK Government decisions to change thresholds and avoids any impact of changes in UK rates. A further update will be provided in the next annual report. Such a policy would of course not have effect until 2018-19 at the earliest.

26. In considering issues relating to the review of the block grant adjustment method (paragraph 79), and to the risk of a significant cumulative divergence, we will be vigilant in ensuring that the SRIT methodology delivers a fair deal for the Scottish budget. However any such arrangements carry with them both up-side and down-side risks. I strongly agree that the Scottish Parliament should be kept aware of these issues as they develop.

**Land and Buildings Transaction Tax (LBTT)**

27. The Committee made a number of points about forecasting of LBTT receipts. I very much agree that the methodology and data used to support forecasts should be published, transparent and open to scrutiny. The proposals set out in my letter to the Committee of 13 November, which the Committee has reflected in the revised Written Agreement, will help to ensure that openness is delivered. As experience is gained in providing forecasts, together with information on outturn receipts, we would expect to work with the Committee to review and if necessary improve the detail of the processes set out in the Written Agreement.

28. As regards responsibility for producing forecasts for devolved tax receipts, I see that resting with the Scottish Government, since we will be best placed to produce forecasts based on knowledge of the operation of the taxes and on Scottish data and experience. Such forecasts would of course be subject to assurance by the proposed Scottish fiscal commission, as described below. I understand that OBR will also need access to forecasts of devolved tax receipts, as an input to their work on UK public expenditure generally. Scottish Government forecasts would of course be available to the UK Government and to the OBR. When we report outturn receipts, we will compare these with Scottish Government forecasts and offer commentary. The OBR has produced a further set of forecasts for SRIT and the devolved taxes to co-incide with the Autumn Statement. These continue to reflect changes in the OBR’s view of tax receipts in Scotland in future.
29. As regards the proposed Scottish fiscal commission (paragraph 91), I look forward to discussing the issues with the Committee when we meet on 8 January. At this stage, however, I can confirm that I expect the commission to be in place in time to provide independent assurance on forecasts of devolved tax receipts for 2015-16 to be included in the draft Budget in autumn 2014.

30. The Committee recommended (paragraph 92) that Revenue Scotland should report 6-monthly on actual receipts from the devolved taxes. In the interests of transparency, it is good practice for tax authorities to report regularly on actual receipts and I expect that Revenue Scotland will follow this pattern by reporting at least every 6 months. Once the details are settled, we will inform the Committee.

**Block Grant Adjustment – SDLT**

31. The two key points here are the level at which to set the initial block grant adjustment, and whether there should be any further changes to the adjustment thereafter. The Committee’s report summarises accurately the respective positions of the Scottish and UK Governments on these questions (paragraphs 109 to 112). They remain under discussion and no agreement has yet been reached. The Chief Secretary to the Treasury and I are aware of the time constraints involved. I note the concern of the Committee about the use of OBR forecasts of SDLT receipts in arriving at the initial block grant adjustment, and I agree with this concern. I am clear that if forecast receipts for SDLT up to 2014-15 are used in the calculation of the initial adjustment, this must be revisited once outturn receipts figures become available and any further adjustment then made to the block grant to reflect actual receipts.

32. I fully agree that the methodology for calculating the adjustment to the Block Grant should be open to scrutiny. As discussed above in relation to forecast receipts, I believe that the revised Written Agreement and the processes underlying it give a good basis for reporting on the calculation of the block grant and for the Committee to exercise scrutiny.

**Block Grant Adjustment - Landfill Tax**

33. The Committee’s report accurately summarises the position on this issue (see paragraphs 118 to 120). The points made above about forecasting of LBTT receipts apply equally to Scottish Landfill Tax (SLfT). We will prepare forecasts of SLfT receipts and will use these in planning our spending in 2015-16 and beyond. The Scottish fiscal commission will have the same role in relation to SLfT receipts forecasts as we envisage it having in relation to LBTT receipts forecasts.

34. In relation to the block grant adjustment for Landfill Tax, the same points apply as made above in respect of SDLT (see paragraph 124 of the report). As the Committee notes in its report, we expect SLfT revenues to fall significantly over the 10 years from 2015 to considerably less than half of the current level. This is a material factor in discussions about the calculation of the initial block grant adjustment and in any discussions about whether it should be revisited thereafter.

**Borrowing Powers**

35. I agree that the limited capital borrowing powers available from April 2015 must be used responsibly. As the Committee notes in its report, we have already made clear in the draft Budget for 2014-15 that we plan to borrow up to the maximum of £296
million in 2015-16 to increase investment in Scotland's infrastructure and secure gains in terms of additional economic activity now and a contribution to efficiency and output in later years. The process for reporting on planned and actual use of the new borrowing powers set out in my letter of 13 November to the Committee and now reflected in changes to the Written Agreement will ensure transparency and give the Committee opportunity to scrutinise and comment or make recommendations on the Government's plans (see paragraphs 127 and 128).

36. The Committee asked why, in the draft Budget 2014-15, the Scottish Government assumes that repayment of loans will be over 25 years at an interest rate of 5% (see paragraph 133). We will use capital borrowing powers to support investment in assets with long lifespans. By matching loan terms to the lifespan of assets, the Scottish Government will improve affordability by spreading the cost of repaying loans. The current NLF rate for borrowing over 25 years is 3.44%. However we chose to use a higher rate of 5% as a prudent estimate underpinning the projections in the draft Budget.

37. With regard to revenue borrowing, as the Committee's report indicates, the Scottish Government will be able to borrow up to £200m annually up to a cumulative total of £500m, with loans repayable within 4 years. Use of this borrowing facility would if necessary give additional time to adjust spending plans in anticipation of changes to the Scottish budget as a result of divergences between forecast and actual figures for SRIT receipts and for the UK NSND tax base. As explained above, any adjustment to the Scottish budget to reflect changes between forecast and actual figures will take place in the first financial year after accounts have been published and audited - effectively three years after the year to which the forecasts related. The Scottish Government expects to receive regular updates on actual receipts and so should have advance warning of variations from forecast. This would give SG some time to adjust spending, if necessary, in anticipation of a Budget adjustment. The facility to borrow up to £200m could be used to give additional time to phase in adjustments to spending – although of course any such loan would then have to be repaid within 4 years.

38. In theory the revenue borrowing facility would also be available to enable us to deal with divergences between forecast and actual receipts for the devolved taxes. Given the smaller sums involved, and the fact that we will plan our spending based on Scottish Government forecasts of devolved tax receipts rather than OBR forecasts, we do not expect this to be a significant issue. Any divergences will be managed over time in much the same way as for non-domestic rates, so that forecasts and actual receipts are kept in balance taking one year with another.

Scottish Government
December 2013