Dear Hugh,

AUDITOR GENERAL FOR SCOTLAND (AGS) REPORT “POLICE REFORM: PROGRESS UPDATE 2013”

I am writing in response to your letter of 26 November 2013 seeking further information on the outcome of discussions between Scottish Government and Her Majesty’s Treasury about VAT arrangements for Police Scotland.

I enclose the exchange of letters from last year between myself and the Rt Hon George Osbourne MP, Chancellor of the Exchequer, and David Gauke MP, Exchequer Secretary to the Treasury on this issue. The response from HMT confirmed that s33 VAT exemption was disallowed due to the switch from local government to central government funding for Police.

KENNY MACASKILL
Dear David

Our officials have been discussing for some time the VAT status of the proposed Scottish Police Authority (SPA) and Scottish Fire and Rescue Service (SFRS). I understand that you have decided that you are not prepared to allow the new bodies to recover VAT.

We have not received any formal reasons for your decision but I understand it is on the basis that the SPA and SFRS will be funded by central government.

We have sought to work with you cooperatively and constructively. This included setting out the ways in which the Police and Fire Reform (Scotland) Bill provides for enhanced local democratic scrutiny of the delivery of policing and fire and rescue creating a new direct relationship with the 32 local authorities, not joint boards. We have reiterated that both SPA and SFRS will continue to be able to receive funding from Scottish local authorities to pay for the cost of agreed local priorities.

I consider that this availability of a local funding mechanism meets your policy as set out in your letter of 29 February to the Scottish Parliament's Finance Committee. However, to provide you with reassurance that our proposals meet your policy, we had shared with your officials options for providing an express provision in the Bill to make that funding link totally explicit. We considered this would demonstrably satisfy your policy and facilitate your decision to make the necessary changes to UK legislation to allow the SPA and SFRS to recover VAT.

It is therefore extremely disappointing that you have rejected our proposals and furthermore have been unable to co-operate with us, failing to provide a credible basis for your decision or to offer suggested amendments that would meet your policy without undermining our whole programme of reform.

Whether or not we can agree that there is an element of 'local funding', we still think there are other compelling reasons for allowing the new Fire and Police Authorities to recover VAT. This will ensure that the reform of Scotland's police and fire services is fiscally neutral, and maintain parity of treatment between police and fire services across the UK.

By failing to agree the continuation of the services' ability to recover VAT, your policy is in stark contrast with your treatment of Academy schools in England. These schools are fully funded by central government. Originally the funding UK Government department (Department for Education) met new VAT costs associated with the shift to central funding and those costs were reimbursed by Treasury. You then changed the rules, by creating a new provision in the Value Added Tax Act 1994, to allow the Academy schools to reclaim VAT thereby taking funding pressure off the Department for Education. You stated to the Public Bill Committee of the UK Parliament on 9 June 2011 that in doing so your "objective is to ensure that we can

Correspondence from Kenny MacAskill MSP, the Cabinet Secretary for Justice, Scottish Government to David Gauke MP, Exchequer Secretary to the Treasury, HM Treasury, 21 June 2012
proceed in a fiscally neutral way" and that "if we did not introduce such a refund scheme, academies would be at a significant disadvantage compared with local authority schools".

This demonstrates the flexibility in the VAT system, where there is a will to do so, to enable Treasury to take steps to ensure that the creation of new public bodies is tax neutral even where they are centrally funded. You were willing to do this for your own initiative of Academy schools, but have refused to do so in respect of the Scottish Government's reform of police and fire services. This is not acceptable.

In the same way as you provided a level playing field for Academies and local authority funded schools, agreeing to SPA and SFRS being able to reclaim VAT would ensure a level playing field for police and fire services across the UK, as well as equitable treatment between UK Government Departments which are leading programmes of reform and the Scottish Government and Parliament.

As you will be aware, an order is being prepared under section 104 of the Scotland Act to make various consequential changes to UK legislation resulting from the Bill. This work is being coordinated by the Scotland Office. Scottish police and fire authorities are currently able to recover VAT under the Value Added Tax Act. With your agreement the necessary minor amendments to that Act to enable this to continue could readily be included in that order as they are clearly consequential on our reform programme. We have already prepared draft amendments for this purpose, which I am more than happy to share with your officials.

On that basis, and in light of the considerations I set out above, I urge you to reconsider your decision and agree to allow both SPA and SFRS to be included as bodies who are entitled to recover VAT under the Value Added Tax Act 1994.

KENNY MACASKILL
Dear Kenny

Section 33 VAT Refund Scheme

Thank you for your letter of 21 June 2012 regarding the VAT status of the proposed Scottish Police Authority (SPA) and Scottish Fire and Rescue Service (SFRS).

The Section 33 refund scheme (s.33) was introduced together with VAT in 1973, following a Ministerial commitment that VAT would not become an additional burden on local taxation. HMRC’s published guidance sets out the long-standing criteria for access to the s.33 scheme. Notably, this includes the requirement for an eligible body to be funded directly through local taxation.

The reforms to Scottish police and fire services, which will see responsibility for these services centralised and moved away from local authorities, mean that the new services no longer meet the eligibility criteria for s.33. This was acknowledged repeatedly by the Scottish Government in correspondence with the UK Government and indeed, as set out in the business case for the reforms, the proposed savings from the changes were ‘predicated on VAT not being provided for’.

Following a request from the Scottish Government we have been working with your officials to explore whether your reforms can be amended to enable s.33 eligibility. However, we have been unable to reach agreement on the inclusion of an element of local funding in your reforms which is crucial for s.33 eligibility. The funding link that the Scottish Government have suggested and to which you refer to in your letter is a provision for local authorities to request additional resources be allocated to local policing, with the additional costs that arise being paid for by the local authority. However, I do not consider this provision to equate to the element of local funding that is required to enable s.33 eligibility for the SPA and SFRS.

Firstly, additional resources, which will often take the form of additional officers, would likely have little impact on VAT costs since staff wages do not incur VAT. Therefore, the purpose for applying s.33 - to prevent VAT becoming a burden on local taxation – does not apply. While a local authority can provide additional discretionary funding to the police, this contribution would, for the most part, not be subject to VAT.

More importantly, as set out in the HMRC guidance, s.33 requires that the relevant body has the power to draw on local taxation. Under the proposed Scottish reforms, neither the police nor fire services will have such a power. Instead the provision of funding would be at the local authority’s discretion.

In your letter you refer to the approach adopted in respect of academy schools in England. I do not accept there is such a parallel here. The fundamental rule for funding public services is that VAT costs are included within upfront funding allocations. VAT refund schemes are an exception to this principle and can only be
justified where there is a specific policy need for one. Academies in England do not have access to s.33. Section 33B was created as a separate refund scheme, because academies did not meet the long-standing eligibility criteria for s.33 that only bodies funded from local taxation are eligible. The introduction of the scheme for academies was necessary because, without it, local authority schools would have had an incentive to maintain the status quo. It is therefore likely that, in the absence of a VAT refund scheme, these education reforms would have been frustrated by a lack of a refund scheme, thus placing the entire reform programme at risk. This contrasts with the decision to proceed with the police and fire service reforms in Scotland, which were made assuming that VAT refunds would be lost. (I also note by your estimates for the reforms, that the savings of £1.7bn over 15 years far outweighs any lost VAT refunds). There is therefore no policy imperative that necessitates the introduction of a new refund scheme to ensure your reforms succeed.

Despite efforts to work with the Scottish Government to enable ongoing eligibility to the VAT refund scheme, we have been unable to persuade you to alter your reforms to introduce an element of local funding which is consistent with the published guidance. As a result I am unable to agree to the new police and fire services continuing to receive VAT refunds.

Separately, you wrote to the Chancellor on 7 June to ask for an in-principle agreement to the making of an Order under section 104 of the Scotland Act 1998, to make consequential provisions arising from the reforms being made to your police and fire services.

The proposed consequential amendments include two issues which are the responsibility of HM Treasury Ministers - provision for pensions for police officers, cadets, special constables and fire-fighters and provisions on the treatment of stamp duty where the right to buy is exercised on a house provided for police or fire and rescue purposes.

I can confirm that I am content for the proposed changes to be taken forward in the Order.

David Gauke MP