Dear Linda

David Mundell and I were grateful for the opportunity to appear before your Committee on 8th September and we look forward to doing so again towards the end of your consideration of the Bill.

Please find below information that I committed to provide to your Committee during the evidence session, I do hope that this information is useful to you:

**Impact of the Scottish Rate of Income tax**

The intention of the measures in the Scotland Bill is not a transfer of funds, but a transfer of power and accountability. They aim to give the Scottish Parliament a bigger stake in the performance of the Scottish economy. Future growth in the Scottish budget will depend on two factors: the growth of the block grant and the growth of tax receipts. Where tax receipts grow faster than public spending, the Scottish budget will be larger - and vice versa.

During the evidence session on 8 September the issue of the effect of the measures in the Scotland Bill was debated. The Scottish Government has claimed that the measures in the Bill could result in a significant loss to Scotland by comparison with the block grant. It published a paper in January 2011 suggesting that if the measures had been introduced in 1999, the Scottish budget would have been cumulatively £8bn lower in 2010-11 than it actually was.

The method underlying this estimate is fundamentally flawed, and the picture it paints is entirely unrealistic. There are a number of ways of calculating the value of the adjustment to the block grant. It is very sensitive to a number of factors: (i) the year in which that adjustment is made; (ii) whether the adjustment is based on data for a single year or an average of years; and (iii) the period of time over which the value of the reduction is calculated. The Scottish Government estimate is based on
making the adjustment using a single unrepresentative year, and simply extrapolating that over a number of years. It paints a thoroughly misleading picture.

The UK Government's technical note, submitted to the previous Scotland Bill Committee, sets out a hypothetical scenario of what could have happened had the changes been made using an average percentage reduction in the block grant from 1999. The period quoted includes the most significant recession in recent years, during which there was an exceptional fall in income tax receipts. During the same period, the Scottish Government would have been better off in 7 out of the 12 years. The estimates showed that, if the reduction the block grant were made in 2011-12 on the basis of receipts in each year, there would be a cumulative gain to the Scottish budget of £2.2bn over the four years to 2014-15.

Extending the model forwards to 2014-15 results in a net gain to the Scottish budget of £397m over the entire period. This is an illustrative model and does not reflect what will happen once the Scottish rate of income tax is introduced. The UK Government is working with the Scottish Government to develop methodology for adjusting the block grant in future and will put in place a transitional period from April 2016 to ensure that the mechanism operates on a basis that it fair to both Governments before the Scottish Government bears any of the risk.

With increased fiscal responsibility comes increased financial risk. Any change away from a block grant funded model to a model reliant on tax receipts will generate revenue risk, due to the potential for falls in tax receipts from one year to the next due to economic circumstances. Under the current block grant model, the UK Government manages this risk on behalf of the Scottish Government. Part of this risk will transfer to the Scottish Government along with the new powers. The UK Government has set up tools for the Scottish Government to be able to manage this risk in future, including the Scottish cash reserve.

Under the UK Government’s proposed model of tax devolution, the Scottish Government will still be part funded by the block grant, meaning that the Scottish Government’s exposure to revenue variation caused by changes in tax receipts is relatively limited. Devolving more taxes would exacerbate the risk to the Scottish budget, with less protection from the stability provided by the block grant.

The UK Government has repeatedly stated in the UK and Scottish Parliaments its commitment to a process that is “transparent, equitable to both the UK and Scottish Governments and Parliaments based on the best data available”. To that end it has established, together with the Scottish Government, a Joint Exchequer Committee to discuss and agree the mechanism for adjusting the block grant, and other aspects of implementation. It will begin work later this month.

**Treasury forecasts**

I was asked to provide details of the accuracy of HM Treasury forecasts for income tax receipts during the evidence session. Forecasting error is a risk faced by all Governments with revenue raising powers. The evidence submitted by the Office of Budget Responsibility to the previous Scotland Bill committee set out a summary of
one-year ahead forecast errors between 2001 and 2010. The average forecast error for this period was around -1.5%.

The new Scottish cash reserve and the current borrowing facility will enable the Scottish Government to manage any forecast variations effectively – in the same way that any Government would, through borrowing or through offsetting other expenditure. To provide additional flexibility, the Scottish Government will be allowed to make discretionary payments into the Scottish Cash Reserve for the next 5 years, up to an overall total of £125m, to help manage any variation in Scottish income tax receipts compared to forecasts in the initial phases of the system. HMT analysis shows that total savings of £125m, together with the revenue borrowing powers will be sufficient for the Scottish Government to manage forecasting errors in normal times. Once the taxes set out in the Bill are devolved, the cash reserve will also be available to save excess tax receipts against forecast.

There also appeared to be a difference of opinion about how the forecast/ outturn reconciliation process will operate, I hope that the following information provides the Committee with greater clarity. In any given year, the Scottish Government will be allocated revenue based on the Office for Budget Responsibility’s (OBR) forecast of income tax receipts for that year. This will give the Scottish Government certainty about how much revenue it will have available in that financial year. Prior to the reconciliation, the Scottish Government will not be required to repay any revenue or borrow.

The reconciliation between forecast and outturn receipts will take place approximately 10 months after the end of the tax year. The reason for the reconciliation taking place after the end of the tax year is because income tax self-assessment returns are not finalised until the January following the end of the tax year so total receipts for a given year are not confirmed until after that point. There will be estimates of receipts coming in on an ongoing basis through the year – they will be made available to the Scottish Government. If the reconciliation shows that the outturn receipts are less than forecast, then the Scottish Government will be required to repay the difference to the UK Government. This could be done through borrowing or by accessing funds within the Scottish cash reserve. If outturn receipts are greater than forecast, the Scottish Government will receive the extra revenues from the UK Government, and be able to either save them in the Scottish cash reserve to offset future variations, or will be able to put them towards spending in the next financial year. As the Scottish Government will have regular information on receipts throughout the year, they can also, if they chose, adjust their spending in year to allow for any expected variation in forecast.

**Role of the Office for Budget Responsibility**

The Office for Budget Responsibility (OBR) was created in 2010 to provide independent and authoritative analysis of the UK’s public finances.

The OBR has four main roles:

- Producing forecasts for the economy and public finances
- Judge progress towards the Government’s fiscal targets
- Assess the long-term sustainability of the public finances
- Scrutinise the Treasury's costings of Budget measures

The OBR will have clear responsibilities for forecasting Scottish Tax receipts. The Command Paper sets out that a Memorandum of Understanding between HMRC, OBR and HM Treasury will ensure, along with any relevant information from the SG, that the OBR has the data it needs to forecast Scottish tax receipts accurately. We placed great emphasis in the Command Paper on how all calculations in relation to the new financing system will be transparent and published to allow independent auditing and scrutiny.

I was also asked about the role that HMRC will play in implementing the new arrangements set out in the Scotland Bill. In the Command Paper we set out how new lines of accountability will be established in HMRC, principally an Additional Accounting Officer being made specifically accountable for the collection of the Scottish rate of income tax. The Scottish Parliament will receive a report on the administration of the Scottish income tax receipts as part of the National Audit Office's annual report on HMRC's overall performance. Scottish Parliamentary Committees will be able to request HMRC Accounting Officers to give evidence.

Corporation Tax:

The HMRC note published on 13 July outlined the detailed methodology used by the UK Government to estimate the cost of a reduction in the corporation tax rate in Scotland to 12.5%. An additional copy of this note is provided with this letter.

HMRC's paper sets out an estimate of the range of possible costs of reducing corporation tax in Scotland to 12.5% in 2015-16. The £2.6bn figure referred to as the amount of figure raised in Scotland through corporation tax is a GVA-estimate published in Government Expenditure and Revenue Scotland 2009-10 [http://www.scotland.gov.uk/Publications/2011/06/21144516/17 ; page 34]. There are two main reasons why comparing the GERS total amount of CT figure with the rate reduction costing is not valid:

- They relate to different years: 2009-10 and 2015-16. Between these years a large increase in total UK wide receipts is forecast. Onshore receipts were £30.2bn in 2009-10 (latest HMRC estimate, against £30.0bn in GERS). The Office for Budget Responsibility's latest Economic and Fiscal Outlook forecasts a rise of over 50% to 45.6bn by 2015-16.

- The rate reduction costing takes into account an estimate of the behavioural effects that would ensure from a rate reduction, such as TMI (tax motivated incorporation - which reduces Income Tax and NICS receipts) and profit shifting (which reduces corporation tax paid on profits arising in other parts of the UK outside Scotland).

The Committee will wish to note that the Calman Commission considered corporation tax and concluded that a different rate of corporation tax in Scotland would potentially create economic inefficiencies as firms arbitraged between Scotland and the rest of
the UK in order to minimise their tax liabilities. This could also lead to “brass plating” where a registered office moves but the underlying economic activity does not. Proponents of devolving Corporation Tax seem to assume that Scotland would have a lower rate. It is not clear that this would be affordable to Scotland. The Exchequer Secretary noted in his evidence to the Scottish Parliament that whilst the UK Government is committed to reducing Corporation Tax by 1 per cent per year until it reaches 24 per cent but that this came at a cost - with each reduction by a penny, by one percentage point, would result in UK receipts falling by around £800 million.

As the Committee will be aware the Scottish Government’s consultation on the devolution of Corporation Tax closed on Monday 5 September. As part of that process, the Exchequer Secretary wrote to the Scottish Government highlighting significant issues which would have to be considered. It became apparent during our evidence session with your Committee that the Scottish Government had published a further paper on Corporation Tax on the morning of 8 September. Unfortunately, the paper does not address any of the points that were put to the Scottish Government by the Exchequer Secretary in his letter, or indicated by other responses received during the consultation period. It is important that these points are addressed and the consultation responses fully considered by everyone, not just the Scottish Government.

**Calman Commission recommendations and recommendations of the previous Scotland Bill Committee:**

Towards the end of our evidence session we covered the delivery of the Calman recommendations and the Government’s response to the recommendations made by your predecessor Committee.

The Scotland Bill is one element of the package of enhanced devolution that we are bringing forward. The Command Paper published alongside the Bill sets out how the other Calman recommendations are being implemented. Many of the Commission’s recommendations did not require legislation, and instead were about improving the way that the UK and Scottish Governments and Parliaments work together. Many of these recommendations have been delivered successfully, such as the recommendations designed to strengthen the Joint Ministerial Committee fora; others are for the two Parliaments to consider and respond to given that they impact on processes and procedures in those Parliaments.

The Bill delivers those recommendations which require legislative change. Of course it is right and proper that we have considered the implications of the recommendations and ensured that we implement them in a way that is effective; sensible and delivers real improvements to people in Scotland. Our considerations take account of the changed environment in which we are operating, for example some recommendations, such as those to devolve Aggregates Levy and Air Passenger Duty are awaiting other decisions and provision is included in the Bill to devolve these at a later date.

We also looked very carefully at the recommendations made by your predecessor Committee. We made several amendments at the next available stage of the Bill in the Commons; these amendments were announced on 13 June and a copy of the
Written Ministerial Statement was provided to your Committee (a further copy is attached to this letter). We have implemented the overwhelming majority of recommendations from your predecessor Committee, including:

- Bringing forward to 2011 pre-payments, a form of ‘cash advance’, to allow work on the Forth Replacement Crossing to begin;

- Removing the requirement for Scottish Ministers to absorb the first £125m of tax forecasting variation within their budget, giving Scottish Ministers more flexibility to decide how best to respond to any variations in tax receipts compared to forecasts;

- Allowing Scottish Ministers to make discretionary payments into the Scottish Cash Reserve for the next 5 years, up to an overall total of £125m, to help manage any variation in Scottish income tax receipts compared to forecasts in the initial phase of the new system;

- Introducing a power in the Scotland Bill which will enable the Government to amend, in future, the way in which Scottish Ministers can borrow to include bond issuance, without the need for further primary legislation.

- Amending the Bill to enabling Scottish Ministers to approve the appointments of MG Alba board members;

- Providing for reciprocal consultation between UK Ministers and Scottish Ministers when either makes changes to electoral administration that impact on their respective responsibilities;

- Devolving the power to make an order disqualifying persons from membership of the Scottish Parliament;

- Implementing the findings of the Expert Group appointed by the Advocate General to consider the working of the Scotland Act in relation to devolution issues concerning the Lord Advocate as head of the system of criminal prosecution in Scotland.
We are continuing to consider other recommendations made by the Committee and will keep you updated on our further consideration. As I set out in my opening remarks the UK Government will consider all further amendments to the Bill against three tests: detailed, evidence-based proposals; demonstrating benefits to Scotland without prejudice to other parts of the United Kingdom; and receiving cross-party consensus.

I hope that this information has been helpful to you and your Committee.

Yours sincerely,

Michael Moore

RT HON MICHAEL MOORE MP
Secretary of State for Scotland
Explanatory Note on estimating the cost of a reduction in the Corporation Tax rate in Scotland

Summary

Measure description
1. Reduction in the Corporation Tax (CT) rate in Scotland for onshore companies.

Key estimates
2. This paper presents provisional estimates of the cost of the option for the main rate and small profits rate of CT in Scotland to be cut to 12.5% from April 2011. The following costings are based on the HMRC Knowledge Analysis and Intelligence (KAI) costing models for the UK-wide main rate CT changes and the small profits rate CT changes. These costing models have been approved by the Office for Budget Responsibility (OBR) for use on UK wide changes. Were any proposals to be taken forward, the provisional figures in this note would be subjected to refinement based on more detailed analysis and would need OBR approval.

3. The estimates also include the net revenue effects from an expected increase in Tax-Motivated Incorporation (TMI) across the following regimes: Self Assessment, PAYE Income Tax, Class 1 Employee & Employer NICs, Class 2 & 4 NICs and CT. The TMI effects are derived from a separate KAI costing model but again are part of the standard methodology for costing UK wide changes. In addition, estimates of the costs of the following other effects have been produced: the impact on receipts relating to the assurance and insurance sector; the additional impact of other large Scottish domiciled companies. More details on these additional impacts are given later in the note in paragraph 25.

4. The estimates are shown in table 1 below; this is followed by details of the methodology.
Table 1: Cost to the UK Exchequer of a reduction in the CT main and small profits rates applying in Scotland to 12.5% (7.0% UK tax base assumption)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(National Accounts Basis, rounded to nearest £5 million)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct effect:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Main rate</td>
<td>-500</td>
<td>-850</td>
<td>-855</td>
<td>-840</td>
<td>-845</td>
</tr>
<tr>
<td>b) Small profits</td>
<td>-5</td>
<td>-200</td>
<td>-285</td>
<td>-310</td>
<td>-330</td>
</tr>
<tr>
<td>c) Marginal Small Profits Rate</td>
<td>0</td>
<td>-55</td>
<td>-75</td>
<td>-75</td>
<td>-75</td>
</tr>
<tr>
<td>Branches (lower estimate)</td>
<td>-170</td>
<td>-290</td>
<td>-290</td>
<td>-285</td>
<td>-290</td>
</tr>
<tr>
<td>Branches (upper estimate)</td>
<td>-315</td>
<td>-540</td>
<td>-545</td>
<td>-530</td>
<td>-535</td>
</tr>
<tr>
<td>Behaviour:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Rest of the World (non-UK) to Scotland with branches lower estimate</td>
<td>125</td>
<td>235</td>
<td>240</td>
<td>220</td>
<td>215</td>
</tr>
<tr>
<td>with branches upper estimate</td>
<td>150</td>
<td>285</td>
<td>295</td>
<td>270</td>
<td>260</td>
</tr>
<tr>
<td>b) Rest of UK to Scotland with branches lower estimate</td>
<td>-245</td>
<td>-470</td>
<td>-480</td>
<td>-440</td>
<td>-425</td>
</tr>
<tr>
<td>with branches upper estimate</td>
<td>-300</td>
<td>-570</td>
<td>-590</td>
<td>-540</td>
<td>-520</td>
</tr>
<tr>
<td>c) Tax Motivated Incorporations</td>
<td>-15</td>
<td>-35</td>
<td>-55</td>
<td>-70</td>
<td>-85</td>
</tr>
<tr>
<td>Total (lower estimate)</td>
<td>-815</td>
<td>-1,660</td>
<td>-1,800</td>
<td>-1,795</td>
<td>-1,835</td>
</tr>
<tr>
<td>Total (upper estimate)</td>
<td>-985</td>
<td>-1,965</td>
<td>-2,105</td>
<td>-2,090</td>
<td>-2,130</td>
</tr>
<tr>
<td>Other possible impacts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Assurance and Insurance</td>
<td>-105</td>
<td>-135</td>
<td>-135</td>
<td>-135</td>
<td>-135</td>
</tr>
<tr>
<td>b) Other Large Scottish Domiciled groups</td>
<td>-330</td>
<td>-440</td>
<td>-440</td>
<td>-440</td>
<td>-440</td>
</tr>
<tr>
<td>Total with other possible impacts (lower estimate)</td>
<td>-1,250</td>
<td>-2,245</td>
<td>-2,385</td>
<td>-2,380</td>
<td>-2,420</td>
</tr>
<tr>
<td>Total with other possible impacts (upper estimate)</td>
<td>-1,420</td>
<td>-2,550</td>
<td>-2,690</td>
<td>-2,675</td>
<td>-2,715</td>
</tr>
</tbody>
</table>

Note: due to rounding some figures may not sum exactly

Introduction

5. This note sets out the methodology and key assumptions used to produce the latest costings. It is divided into:

- Section A explains how the tax bases have been estimated;
- Section B sets the calculation of the static (pre-behavioural) yield;
- Section C sets the calculation of the post-behavioural yield;
- Section D flags the issues of second round effects.

A - Establishing the tax base

Main rate

6. Estimates of UK onshore CT accruals relating to companies paying the main rate of CT are taken directly from the UK CT forecast for the quarterly instalment payments of non-life companies. This forecast is calibrated to an estimate of 2010-11 accruals based on latest tax
receipts, and then projected in line with the economic determinants underlying the forecasts in the OBR March 2011 Economic and Fiscal Outlook. It excludes UK oil and gas revenues.

7. The CT accruals base used also takes account of the estimated effect of the March 2011 Budget corporate tax rate changes. Thus the underlying CT main rate used is 26% in 2011-12, 25% in 2012-13, 24% in 2013-14 and 23% in 2014-15; while the small companies rate is 20% in 2011-12 and subsequent years.

8. The proportion of onshore UK CT receipts which relate to Scotland is estimated to be 7%. The methodology used in deriving this proportion is consistent with the estimates of the cost of a CT rate change in Northern Ireland published in the HM Treasury Consultation document, *Rebalancing the Northern Ireland economy*. Companies whose registered address has a Scottish post code, excluding UK oil and gas companies, have been identified, and the total CT accrual from these companies has been calculated. Estimates have been produced in this way for 2004-05 to 2008-09. Across these years, Scottish registered companies make up around 7 per cent of total UK onshore CT accruals. This proportion is applied to the UK main rate CT accrual (as described in the preceding paragraphs) to arrive at an estimate for main rate onshore CT accruals relating to Scotland.

9. Separate analysis by the Scottish Government and based on ONS Regional Accounts (see 'Government Expenditure and Revenue Scotland 2009-2010', published 22 June 2011) produces an average estimate of 8.6% across the years 2005-06 to 2009-10 as the Scottish share of onshore CT receipts (see paragraph 12 and 13 and the discussion of branches).

**Small profits / Marginal small profits rates**

10. To estimate the size of the tax base over the costings period, the tax base is assumed to grow in line with the OBR forecast of CT accruals from companies which do not pay by quarterly instalments. This forecast is calibrated to an estimate of 2009-10 accruals based on latest tax receipts and then projected in line with economic determinants from the March 2011 Budget economic forecasts. The forecast is then apportioned between companies according to whether their profits are taxable at the small profits rate or the marginal small profits rate. In line with the assumption that 7% of the CT tax base pertains to Scotland used for the main rate, this proportion is also applied to the small profits and marginal small profits rates tax bases to arrive at figures for Scotland.

**B - Estimating the static (pre-behavioural) yield**

11. The pre-behavioural Exchequer cost for main rate and small profits rate is calculated by applying the pre and post measure tax regimes to the tax bases described above. Reducing the rate to 12.5% in Scotland incurs a direct (pre-behavioural) annual cost by the end of the

---

1 See: [http://www.hm-treasury.gov.uk/consult_rebalancing_ni_economy.htm](http://www.hm-treasury.gov.uk/consult_rebalancing_ni_economy.htm)
forecast period of £1,250m (excluding branches), and a further cost between £290m and £545m for branches, though—given the preliminary nature of these estimates—these estimates could be subject to change.

Companies with operations crossing the Scottish border

12. A provisional range has been estimated for the direct impact on CT receipts from companies that are based in other parts of the UK but with significant operations (branches) in Scotland. Estimating the size of the 'branches' CT base in Scotland is complex. The true figure is likely to be within the presented range however the figures are subject to change should a more detailed analysis be conducted. In addition, the presence of a number of large groups with headquarters in Scotland could have a further impact (see paragraph 25).

13. The lower end of the range has been informed by the Scottish Government's own analysis which suggests an average Scottish share of CT receipts of 8.6% between 2004/05 and 2008/09. Provisional findings from work done in the context of Northern Ireland can be applied to the Scottish context to give a rough upper estimate of the total Scottish CT base of around 10.1% of the UK total.

C - Estimating the post-behavioural yield

14. Behavioural effects would arise because of the difference in corporation tax rates between Scotland and the rest of the world, between Scotland and the rest of the UK and because of the difference between tax paid by employed and self employed individuals and companies.

15. The two behavioural effects which are covered by this note are profit shifting and tax motivated incorporation (TMI). Profit shifting arises where companies manipulate transactions so that their taxable profits arise in lower tax jurisdictions, while the activities generating those profits remain in a high tax jurisdiction. TMI occurs because a lower CT rate would increase the tax differential between incorporated and unincorporated businesses, which would lead to more unincorporated businesses, with activity in Scotland, incorporating to reduce their tax bill.

Profit shifting

16. The main rate costing model (approved by the OBR for UK-wide main rate changes) contains a behavioural element to incorporate the sensitivity of the UK tax base to changes in the CT main rate (profit shifting). It is important to consider this when costing changes to the CT main rate because this is a potentially significant behavioural effect arising as a result of changes in the CT main rate. To estimate the impact of profit shifting there are broadly two areas to consider, firstly the mobile tax base and secondly the elasticity to apply to it.
Estimating the mobile tax base

17. There are two elements to the calculation to estimate the proportion of the tax base that is mobile, before applying the elasticity:
   a) Identify profits/receipts from sectors likely to contain firms with mobile profits as a proportion of profits/receipts from all large companies – we estimate this to be 83%.
   b) Identify the proportion of profits within the mobile sectors that are deemed to be truly mobile – estimates are between 35% and 65%, with 50% being deemed central (and is used for these purposes).
   c) Combining the two assumptions gives overall mobile proportions of the tax base of 29%, 42% and 54%. The 42% is used as a central estimate and is consistent with Budget 2011 costings.

Estimating the elasticity

18. There are two main elasticities needed. The first is the 'cross border' elasticity which looks at how companies might shift their 'mobile' profits between the rest of the world and Scotland. Based on a literature review completed in 2007 in HMRC KAI, which suggested the range of plausible elasticities lies between 0.3 and 6.9, a central and constant (cross-border) elasticity of 2 is applied.

19. The second elasticity looks at how companies might move profits from the rest of the UK to Scotland. As part of the costing of a Northern Ireland rate change, use was made of findings in the 2007 Varney report regarding in-country profit shifting, which is an additional consideration for the costs of rate changes within a country. Without any additional research into alternative estimates for this particular elasticity, this methodology uses the elasticity of 4. Whilst 4 was used by the Varney report as a central estimate, the report warns that this is conservative and crucially depends on the assumption that the UK would introduce strict anti-avoidance rules to limit the scope of internal profit shifting. Overall, it seems sensible that the elasticity for in-country profit shifting is greater than cross-border elasticities of profit shifting. However, whilst 4 has been used so far in both the Northern Ireland and Scotland analysis, it could be argued that there is greater scope for profit shifting between English and Scottish companies, so in context of Scotland–beyond the cautions raised by Varney–this means that an elasticity of 4 may tend to under-estimate the true effect.

Profit shifting scenarios

20. By combining the above assumptions and applying them to the CT tax base used here for the main rate, a value for behavioural costing effects can then be fed into the main rate costing model, which then derives the overall behavioural effects on a cash basis. The "Rest of the World (non-UK) to Scotland" line in the table shows the effect of multinational companies transferring some of their mobile profits from outside the UK to Scotland, the
resulting increase in profits arising in Scotland produces an increase in CT receipts. The rest of the UK to Scotland line shows the effect on the UK exchequer from companies shifting profits within the UK to Scotland and consequently being taxed at a lower average rate.

21. Due to the rate cut taking effect immediately in 2011/12, it is also assumed that 75% of the full year behavioural effect is reached in 2011/12 and then 100% of it in 2012/13 and then continuing that behavioural effect at a constant level for the rest of the forecast period.

**Tax Motivated Incorporation (TMI)**

22. A decrease in the small profits rate for Corporation Tax increases the incentive to incorporate for both employees and the self-employed. This leads to more incorporations as the difference in the tax regimes widen. An increase in the number of tax motivated incorporations will in turn increase corporation tax receipts, however there will also be a negative adjustment made to the Income Tax and National Insurance receipts.

23. The number of new Scottish incorporations as registered with Companies House makes up approximately 5.2% of the total number of incorporations. In 2011-12, it is estimated that following the decrease in the small profits rate, there will be an additional 6,000 TMI. The number of additional TMI in the following tax years takes the profile of 100%: 50%: 25%: 12.5% as agreed with the OBR. This reflects the immediate change in behaviour following the announcement of the tax change, which is assumed to decline over time.

24. The estimates of the TMI effects do not take into account any TMI registering in the rest of the UK and deciding to switch to a Scotland base to take advantage of the lower CT rate. Any such businesses that wanted to register in Scotland to benefit from the rate cut would still have to prove that their activities had legitimately been moved to Scotland. These new companies may be deterred to some extent by the additional administrative burdens placed on them. Overall the TMI cost is likely to be an under-estimate but the extent of this is uncertain.

**Other impacts**

25. There are certain other potential impacts of a cut in the Scotland CT rate for which estimated costings have been provided. They reflect the differences in the business populations in Scotland and Northern Ireland, for example the presence of a number of large groups with headquarters in Scotland:

- There is a significant presence of life assurance and general insurance companies in Scotland. In the event of a rate cut it is extremely likely that all profits generated by life and general insurance companies domiciled in Scotland would be allocated there and thus taxed at the lower CT rate. After taking into account that a proportion of the profit shifting behavioural cost presented above applies to this sector, the additional estimated cost of this effect is £135 million by the end of the period.
Moreover there would also be a strong behavioural incentive for large English and Welsh-domiciled companies in these sectors (who commonly have a Scottish presence/subsidiaries) to relocate their technical funds to Scotland, increasing the cost to the Exchequer, though we have not yet attempted to quantify this effect.

- A similar issue is that a number of other large banking, other financial and industrial groups are headquartered in Scotland. These groups pay CT through their Scottish parent company. In the event of a rate cut and Scottish ring-fence these companies are likely to find it easier to claim that the CT arises in Scotland. The issue is particularly relevant to other types of financial groups domiciled in Scotland such as banks. The extent of this particular risk would depend on how effective legislative defences against unreasonable profit shifting were in the wake of any CT rate cut. The estimated cost is about £440 million by the end of the period.

**Administrative costs**

26. The administrative burden on companies would increase, with companies now having to account for profits in Scotland separately to those in the rest of the UK. The resultant increased costs have yet to be calculated but would, necessarily, increase the overall costs of the measure.

**D – Second round effects**

27. Second round effects on tax receipts (i.e. those flowing from the change in economic activity stemming from the behavioural response to lower tax rates) of this measure are not included in the assessment. Such effects have yet to be considered.
Written Ministerial Statement

The Scotland Bill

Secretary of State for Scotland: Michael Moore

The Chancellor and I are today announcing changes to the Scotland Bill and accompanying package that will further strengthen Scottish devolution and provide greater financial responsibility to the Scottish Parliament.

The Coalition Government’s Programme for Government set out that the Government would implement the proposals of the Calman Commission. The Scotland Bill currently progressing through Parliament delivers this key coalition commitment.

The Scotland Bill will introduce a new Scottish rate of income tax, fully devolve stamp duty land tax and landfill tax, introduce a new capital borrowing power and extend current borrowing powers.

When combined with the existing tax raising powers of the Scottish Parliament, the Bill will provide Scottish Ministers with a total of £12bn worth of financial powers and it represents the largest ever transfer of financial power from Westminster to Scotland. Through taking on responsibility for raising the taxes required to fund the spending decisions they make, the Scottish Parliament will be more accountable to the Scottish people. Once the measures are fully implemented the Scottish Parliament and Scottish Ministers will have more powers, will be more accountable, and will be better equipped to respond to Scotland’s needs within the United Kingdom.

Since the introduction of the Scotland Bill in November 2010, the Bill has been subject to detailed consideration in both the UK Parliament and the Scottish Parliament. The Bill has successfully passed through Committee stage in the House of Commons and in March 2011 the Scottish Parliament voted overwhelmingly in support of a Legislative Consent Motion agreeing to the measures set out in the Bill, by a margin of 121 to 3.

The UK Government has considered carefully the recommendations made by the Scottish Affairs Committee in the UK Parliament and the Scotland Bill Committee in the Scottish Parliament. It has also committed to listen carefully to any detailed proposals put forward by the Scottish Government.

Based on the evidence received so far, the Government continues to believe that the package set out in the Scotland Bill and the supporting Command Paper meet the objectives of strengthening Scottish devolution within the United Kingdom and in particular providing strong financial accountability to the Scottish Parliament. However, the UK Government has decided to make some amendments to the Bill and supporting package that ensure that Scottish Ministers have greater flexibility to exercise their new powers effectively.

Therefore the Chancellor and I propose the following changes to the Scotland Bill and accompanying package:

- Bringing forward to 2011 pre-payments, a form of ‘cash advance’, to allow work on the Forth Replacement Crossing to begin;
- Removing the requirement for Scottish Ministers to absorb the first £125m of tax forecasting variation within their budget, giving Scottish Ministers more flexibility to decide how best to respond to any variations in tax receipts compared to forecasts;
- Allowing Scottish Ministers to make discretionary payments into the Scottish Cash Reserve for the next 5 years, up to an overall total of £125m, to help manage any variation in Scottish income tax receipts compared to forecasts in the initial phase of the new system;
- Introducing a power in the Scotland Bill which will enable the Government to amend, in future, the way in which Scottish Ministers can borrow to include bond issuance, without the need for further primary legislation. The Government will conduct a review of the costs and benefits of bond issuance over other forms of borrowing, and will consider extending Scottish Ministers’ powers where this does not undermine the overall UK fiscal position or have a negative impact on total UK borrowing.

In addition a number of changes will be made to the non-financial sections of the package:

- Enabling Scottish Ministers to approve the appointments of MG Alba board members;
- Providing for reciprocal consultation between UK Ministers and Scottish Ministers when either makes changes to electoral administration that impact on their respective responsibilities;
- Devolving the power to make an order disqualifying persons from membership of the Scottish Parliament;
- Implementing the findings of the Expert Group appointed by the Advocate General to consider the working of the Scotland Act in relation to devolution issues concerning the Lord Advocate as head of the system of criminal prosecution in Scotland;
- Strengthening inter-governmental dialogue in areas of mutual interest in welfare.

The Government believes the Scotland Bill provides the right balance of additional powers for Scotland. But we will study any further proposals by the Scottish Government based on robust evidence on how these proposals would benefit both Scotland and the rest of the UK.