Session Four
Scotland Bill Committee
PwC written response to call for evidence

September 2011
Linda Fabiani, MSP  
Convener, Scotland Bill Committee,  
Scottish Parliament  
Room TG.01  
Edinburgh  
EH99 1SP  

23 September 2011

Scotland Bill Call for Evidence

Dear Ms Fabiani

I refer to your July 2011 consultation document, Scotland Bill Call For Evidence, and I am pleased to attach the PwC response in respect of a range of financial and non-financial proposals.

I am a tax partner in PwC, based in Edinburgh and am responsible for our comments on devolved taxation matters.

We note that in the consultation document that the Scotland Bill Committee has sought responses in respect of a range of financial and non-financial proposals.

While the issues are wide-ranging and diverse, we have restricted our response to those areas where we believe we can add value to the debate.

I trust that this helps to inform an outcome that is favourable to Scotland and should you require any further information, please do not hesitate to contact me or my colleagues, Paul Brewer, Craig Stobo or Lynn Hunter.

Yours sincerely,

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Preamble

In responding to the invitation to comment on the Scotland Bill Committee’s call for evidence, PwC believes that it is well qualified to comment authoritatively, constructively and independently.

PwC is the largest professional services organisation in the UK; and in the world. In Scotland, PwC employs over 850 people and provides advisory services to government departments, public bodies and agencies, as well as to organisations throughout the private sector.

PwC has advised government in respect of a number of wide-ranging economic and statistical projects. We are both familiar and experienced with economic forecasting and appraisal, with the association between PwC and the University of Strathclyde’s Business School delivering the Fraser of Allander Economic Commentary on the Scottish economy. This complements other PwC economic publications including the quarterly UK Economic Outlook and Northern Ireland’s Economic Outlook, while our Public Sector Research Centre (PSRC) is PwC’s source of insights, opinion and research, exploring best practice, views and perspectives on the most pressing challenges being faced by governments and public services across the world.

One of our recent publications, *A Time for Change? The citizens’ view of public services in Scotland*, was widely acknowledged as an important contribution to the Christie Commission’s examination of how the country’s public services can be delivered in future to secure improved outcomes for local communities.

We note that in the consultation document, the Scotland Bill Committee has sought responses in respect of a range of financial and non-financial proposals.

While the issues are wide-ranging and diverse, we have restricted our response to those areas where we believe we can add most value to the debate.

We also note that the original consultation document poses a number of questions and seeks answers, suggestions and proposals in respect of those questions. Particularly in the areas of Corporation Tax and wider tax-varying powers, we believe that some questions cannot be answered definitively insofar as insufficient information and/or policy proposals are in the public domain. Where we have identified such situations we have commented accordingly.

Finally, we have made a number of points not specifically requested in the consultation document where we believe these points will inform decision making on the wider policy issues.
Executive summary

• The proposal to consider devolving the power to the Scottish Parliament to vary the higher rates of income tax independently of the basic rate would, in theory, potentially enable a more flexible use of this taxation power to influence the Scottish economy.

• However, care should be taken to ensure that devolving such power does not add further complexity, a greater administrative burden and costs to business and indirectly to taxpayers. In addition, there remain complex questions on the interaction between the Scottish Income Tax (SIT), pensions and benefits which require to be addressed prior to implementation of such a proposal.

• We consider that the proposed Joint Exchequer Committee (JEC) is a sound measure which is necessary given the range of new powers proposed. It is desirable that a JEC would have oversight over linked issues such as taxation, administration and grant funding.

The last of these is an area to which much consideration and work would need to be done in transition to a new devolved taxation system.

• Any significant devolution of tax varying powers will have consequences in respect of the block grant and we note that the May 2010 Programme for Government (PfG), from the Westminster coalition government inferred that Barnett would move to a ‘needs-based’ formula and, while change was inevitable, this may be deferred beyond the duration of the current parliament.

• Nevertheless, we believe that not enough consideration has yet been given to the implications of devolving tax-varying powers on the block grant and on any future modifications to Barnett. We believe remedying this omission should be a priority.

• We consider reform of the legal accountability of HMRC should extend to the Scottish Government. If the Scottish Income Tax (SIT) is to have force of law in Scotland as elsewhere in the UK there needs to be a mechanism whereby HMRC can be called to account by the lawmaking body in the relevant jurisdiction.

• We believe that economic development policy and fiscal policy should be holistic and aimed at attracting greater numbers of high-GVA FDI undertakings,
stimulating greater international competitiveness amongst indigenous undertakings and creating sustainable employment. Developing fiscal instruments intended to stimulate these objectives should therefore be primary goals in any review of Scottish fiscal autonomy and flexibility.

- Low Corporation Tax is not a key driver of investment for FDI locating in the UK\textsuperscript{1}, ranking 17th in a list that prioritised: language, culture and values; infrastructure; skills; and proximity to markets. Nevertheless, a survey of the tax regimes of 182 countries\textsuperscript{2} placed the Republic of Ireland as the seventh most business-friendly tax regime, with the UK (incl. Scotland) in 16th place.

- Where tax does influence investment, issues are considerably more complex than the headline Corporation Tax rate, ranging from bilateral arrangements on the taxation of foreign income, to the total tax rate (the sum of all taxes in the destination region), the complexity of the (host) tax regime, and the number of different taxes a typical FDI company may have to pay in the host country.

- No reliable and agreed figures are available relating to:
  - the value of corporation tax raised in Scotland;
  - the cost (to the block grant) of reducing corporation tax to 12.5%;
  - additional compliance and administrative costs;
  - the flexibility of the Azores Judgement to permit greater devolution of taxation (beyond corporation tax);
  - whether or not the Scottish Government could retain income from ‘new’ taxes raised.

All of the above must be quantified and agreed prior to any reasoned debate being possible.

- We believe that the devolution of excise duties, while feasible, could result in serious distortions in product pricing between Scotland and England/Northern Ireland; we are not convinced that such sub-regional variation would be manageable without some ‘border controls’.

- We believe that the devolution of both AGL and APD are both feasible and would provide the Scottish Government with additional fiscal flexibility.

\textsuperscript{1} Ernst & Young 2010, European Investment Monitor, E\&Y, London.
We have responded on the financial issues recommendations only.

There has been little detail or discussion so far on how the new income tax arrangements will be administered by HM Revenue & Customs. Any new system of collection should not undermine the current efficacy of the UK PAYE system and the need for transparency, clarity and efficiency in its operation will be central to winning over business.

We also have concerns as to the potential pitfalls associated with considering the implications of devolving tax-varying powers on a case-by-case basis. Where a number of powers are being considered for devolution the potential impact on each other has to be considered as does the cumulative effect upon the administrative and compliance costs.

On the absorption of tax forecasting variation
We note that the UK Government has proposed that the Scottish Government should no longer have to absorb the first £125m of tax forecasting variation within their budget and agree that this should provide more flexibility for the Scottish Government. This, together with the proposed ability for the Scottish Government to make discretionary payments into the Scottish cash reserve for the next five years up to a total of £125 million, should lessen to an extent the likelihood of unexpected fiscal shocks on the Scottish budget and is consistent with the ‘safety first’ approach set out in the UK Government’s Command Paper.

While the current economic backdrop remains fragile and the transfer of powers on income tax is some years hence, it appears prudent to mitigate risks to the public purse as far as possible should unfavourable economic conditions re-emerge, whether in a UK or Scottish context; these additional powers will assist in that process.

However, it could be argued that, if greater fiscal devolution infers increased fiscal responsibility, the Scottish Government should accept responsibility for any decrease in tax receipts that accrue as a consequence of its taxation or economic policies. The potential difficulty in disentangling the fiscal impact of policies enacted by the Scottish Government from those of the UK Government have been addressed somewhat by the more generous provision in the Scottish cash reserve, albeit in context, the amounts involved at the outset are relatively small compared to the overall Scottish budget.

A more creative use of this reserve, including an increase in its value, could be envisaged once the new devolved system of taxation had become established; and, if used prudently, this reserve could potentially reduce the borrowing requirement.

On earlier introduction and higher limits for capital borrowing
We note the Committee’s call for an earlier introduction of, and higher limits on, capital borrowing powers. The UK Government’s bringing forward of pre-payments to enable work to begin on the Forth replacement crossing is a positive step in meeting that request, as is the review of the Scottish Government’s ability to issue its own bonds directly. We comment further on this point in section two.

On the Joint Exchequer Committee (JEC)
We consider that the proposed Joint Exchequer Committee (JEC) is a sound measure which is necessary given the range of new powers proposed. It is desirable that a JEC would have oversight over linked issues such as taxation, administration and grant

1. Views on the proposals to strengthen the bill made by Session 3 Committee.
funding. The last of these is an area over which much consideration and work will need to be done once the transition begins to the new devolved taxation system.

**On the implications for the block grant**

Any significant devolution of tax varying powers will inevitably have consequences in respect of the block grant. In this regard, in its May 2010 Programme for Government (PfG), the Westminster coalition government referred to the deliberations of the Holtham Commission and, “...recognised the concerns expressed by the Holtham commission on the system of devolution funding... [but concluded]... any change to the system must wait the stabilisation of the public finances.” Effectively this means that any change to the Barnett Formula has been deferred, possibly – but by no means certainly – for the duration of the current parliament.

Calman was less certain than Holtham in respect of its role in modernising Barnett. Nevertheless, it acknowledged that the Barnett formula is often criticised as not being properly linked to any agreed measure of need and therefore leading to an outcome which is over-generous to Scotland.

However Calman also acknowledged that agreeing what is a fair measure of need is difficult, and using it to determine a level of spending seen as fair is a highly political process. Nevertheless, Calman acknowledged that need is the only basis on which grant funding can be properly justified, and it should be need for the common welfare services that comprise the social union.

In that regard, the implication of the Holtham commission and the Programme for Government (see above) would also suggest that reform of the Barnett Formula is almost certain and we therefore believe that the implications of reform are clearly understood by both Westminster and Holyrood, in the context of further devolution. The current effect of the Barnett Formula implies either a slow squeeze down towards English levels of spending per capita or if Barnett is replaced by a needs-based approach a possibly more sudden (negative) adjustment to spending levels. In the context of devolution bringing a wider range of tax varying powers (perhaps including Corporation Tax, Air Passenger Duty, Aggregates Levy) the Scottish Government (as well as the devolved administrations in Wales and Northern Ireland) will face some increasingly tough decisions about future public expenditure, as pressure increases, across the UK, to replace Barnett with a new, more equitable and needs-based formula.

There is an assumption in the HMRC paper that there would be an overnight reduction in Corporation Tax and therefore an immediate cut in the block grant. But that needn’t be the case.

When there is clarity around outstanding issues, a reduction in Corporation Tax could be deferred or phased in over three or four years. This would give the Scottish Government the opportunity to market this, as well as any other incentives intended to enhance productivity, in advance of their introduction, but without penalty to the block grant, during the early phase.

**On accountability of HMRC**

We consider reform of the legal accountability of HMRC should extend to the Scottish Government. If the Scottish Income Tax (SIT) is to have force of law in Scotland as elsewhere in the UK there needs to be a mechanism whereby HMRC can be called to account by the lawmakers in Scotland.
the relevant jurisdiction. Moreover, given the suggestions surrounding different methods of collection for the replacement tax for Stamp Duty Land Tax as well as the ability for a distinctive Scottish system of taxation to develop purely from the powers as currently proposed by the Scotland Bill (e.g. the creation of new taxes with consent), we consider it reasonable to consider the formation of a distinctive Scottish Tax Department within HMRC which will be familiar with the additional aspects of the Scottish devolved taxes.

This will be particularly pertinent should the Scottish Parliament subsequently decide to amend or introduce new, specifically Scottish taxes – if it has the ability to make tax law, it is necessary for the collection and administration agency (whatever form that may take) to be accountable to the lawmakers. A Scottish Tax Department would mirror the revised taxation settlement and would appear the most appropriate way in which to ensure that the evolving Scottish taxation system functioned efficiently and effectively.

This accountability should extend to the costs of administration and collection and scrutiny by the Scottish Auditor General.

We deal with Corporation Tax separately in this paper.

6 UK Government Command Paper.

7 We note that the Committee seeks formal assurance that the UK Government will not unreasonably withhold its agreement for any new proposals to create new devolved taxes.
2. SIT/reduction in block grant.

a. Comment on the effect of these proposals on the finances of the Scottish Parliament and its ability to fund public services.

The Scottish Income Tax (SIT) has the potential to either increase or reduce the finances of the Scottish Government depending on how it works in practice.

It is clear that there needs to be an inbuilt provision whereby Scotland is not adversely impacted by decisions taken by the UK Government on the headline rates for the Basic, Higher and Additional Higher rates or from any decisions to alter the tax base.

There is further work to be done on both the implementation of the new SIT powers and its interaction with both pensions and welfare benefits as well as the effective collection, administration and policing of the new devolved tax provisions.

For instance, for companies throughout the rest of the UK who have Scottish taxpayers, there needs to be an effective and simple means of collecting the SIT which is enforceable in order to ensure that there is no creation of a tax gap. An extension of self-assessment would not be desirable in this respect as one of the efficiencies of the current UK tax system is that it does not have universal self-assessment.

More broadly, the impact on the Scottish finances will initially depend on the decision whether or not to mirror the UK Government’s rates or to reduce or increase these. While there is not the same population concentration around the Scotland/England border as around the Wales/England border, if there were to be a significant increase in rates in one jurisdiction, this could lead to some degree of relocation which could impact on the Scottish budget.

b. The ability of the Scottish Government to stimulate economic growth.

The creation of the new revenue streams for the Scottish Government from SIT and the Scottish equivalents for Landfill Tax and Stamp Duty Land Tax and other devolved taxation (such as Corporation Tax) will impact on the block grant and greater clarity on these effects must be gained. As previously stated, a much clearer understanding of the implication(s) of reform of the Barnett Formula and of the implications of the Azores Ruling is essential to satisfactorily evaluate the implications of devolving fiscal flexibility.

There have been concerns expressed\(^8\) that the proposed SIT could have a negative effect on the Scottish economy. There is little evidence to suggest that the SIT on its own would have either a positive or negative effect on the wider economy\(^9\). Indeed, it is possible that lowering rates could have a beneficial effect on the number of smaller start-up businesses in Scotland and in turn, stimulate the economy from the grass roots.

However, the overall objective of the Scottish Government is to stimulate wealth creation through greater economic activity, attract new foreign direct investment (FDI) and to create sustainable employment. After London and the South East, Scotland is one of the better performing of the 12 UK regions, with above-average growth in recent years, with the Fraser of Allander (FoA) Economic commentary (March 2011) indicating that Scottish growth (GVA per capita) averaged 2.0% over the period 1963-2009 compared to a UK average of 1.9%.

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\(^{8}\) ‘A Fairer Local Tax for Scotland’ Scottish Government consultation, November 2008.

\(^{9}\) Response to the Scottish Government consultation ‘A Fairer Local Tax for Scotland’; CBI Scotland, June 2008.
Scottish GVA per head compared to sample UK regions 2004-9 (UK average = 100)

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Source: ONS 2 August 2011, Productivity Measures by Region

Analysis of the Scottish economy suggests that a number of weaknesses exist. These include:

- **Narrow export base** – Scotland’s export base is declining, is narrowly focussed, and may have been eroded further in the recession. Comparatively few firms contribute to a large share of total exports (60 being responsible for about one half in Scotland) and a small range of sectors (e.g. chemicals, food and drink, tourism and banking) selling to a limited number of countries.

- **Tourism** – Demand from Scotland, the rest of the UK, abroad and business trade have continued to decline (in Q1 2011) while Visit Scotland figures suggest little improvement in either room or bed occupancy for the past 4 years. More could be done to increase the “quality” of the visitors attracted (notably in terms of per capita spending).

Nevertheless, it is worth noting that Scottish productivity in key sectors like manufacturing, construction and agriculture are all significantly above the UK average suggesting that a greater number of internationally-competitive undertakings and a substantial increase in R&D investment would complement existing productivity to stimulate economic growth (see table below).

It is therefore reasonable to suppose that economic growth targets would be based around primary objectives of attracting greater numbers of high-GVA FDI undertakings and stimulating greater international competitiveness amongst indigenous undertakings. Developing tax and fiscal instruments intended to stimulate these objectives would therefore be primary goals in any review of Scottish fiscal autonomy and flexibility.

10 Fraser of Allander Economic Commentary, June 2011.
11 Northern Ireland Economic Outlook, July 2011, PwC, Belfast.
12 Northern Ireland Economic Outlook, July 2011, PwC, Belfast.
13 Fraser of Allander Economic Commentary, June 2011.
14 Northern Ireland Economic Outlook, July 2011, PwC, Belfast.

Opinion on:

a. Proposal for control of Corporation Tax and how it impact the Scottish economy and Scottish public finances

A low and competitive rate of Corporation Tax (CT) would be a key driver in helping to rebalance and grow the Scottish economy. However, evidence suggests that low Corporation Tax alone, without other fiscal incentives and an overarching economic development strategy, is unlikely to deliver the cost-effective increase in Scottish economic growth that successive governments, both Scottish and UK, have sought.

Any new measures to make the Scottish economy more competitive must attract significant levels of FDI, while also stimulating increased productivity, exports and international competitiveness amongst both FDI and indigenous businesses. Most research suggests that, as compared to indigenous firms, FDI brings to the host region higher levels of productivity, greater capital investment and more highly skilled labour opportunities. So, by targeting and delivering FDI that significantly outperforms the median the Scottish economy will benefit from higher levels of productivity, greater international competitiveness and sustainable job creation.

Most observers look to the Republic of Ireland (RoI) for illustrations of how low levels of CT can stimulate high levels of FDI and associated R&D and productivity. Indeed, during 2010, when global FDI declined by 8% the RoI captured 126 new FDI projects of which 47 (37%) were first-time investors and 37 were pure R&D. Collectively 2010 delivered the Irish economy 11,000 new jobs and half a billion euro of new investment in R&D and innovation. Ireland’s 12.5 percent Corporation Tax (CT) has helped drive economic prosperity, hence the argument that matching Ireland’s 12.5 percent rate could transform Scotland’s economic fortunes.

While the Republic’s CT rate helps define its current position as a preferred FDI location, today Ireland is cluster-focused, with technology and pharmaceutical companies locked into Ireland’s universities, R&D, innovation and skills networks. Eight of the world’s top-10 pharma companies are based in RoI accounting for almost half of Ireland’s total exports.

And while a competitive level of Corporation Tax is desirable to ensure Scottish competitiveness, there is no clear evidence of a simple correlation between low Corporation Tax per se and high levels of FDI. The main factors are:

- Low Corporation Tax is perceived by some regions as an incentive to FDI and since 2000, over 80 countries have cut their headline rate of Corporation Tax rates.

- A recent study indicated that low Corporation Tax is not a key driver of investment for FDI locating in the UK, ranking 17th in a list that prioritised: language, culture and values; infrastructure; skills; and proximity to markets.

- A survey of the tax regimes of 182 countries however placed the Republic of Ireland as the seventh most business-friendly tax regime, with the UK (incl. Scotland) in 16th place.

- Where tax does influence investment, issues are considerably more complex than the headline Corporation Tax rate, ranging from bilateral arrangements on the taxation of foreign income, to the total tax rate (the sum of all

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taxes in the destination region), the complexity of the (host) tax regime, and the number of different taxes a typical FDI company may have to pay in the host country.

In terms of the impact of low Corporation Tax as a direct driver of FDI in the Republic of Ireland, extensive research by PwC concluded\(^\text{17}\) that:

- The Republic of Ireland had low Corporation Tax for three decades before the Irish economy began to grow rapidly, while during the 1980s – the period of the boom in US FDI – there were no changes in the Irish tax system.

- As the rate of Irish Corporation Tax rate actually increased in the 1980s, it is not therefore straightforward to invoke low Corporation Tax as an explanation for the timing of the boom.

- It is likely that a growing skills base, a business-friendly administration, membership of the EU, operating costs and a period of aggressive and sustained US investment in European markets all combined with low Corporation Tax to create the ‘Celtic Tiger’.

- We note that, while RoI retains Corporation Tax at 12.5%, this is now complemented by other incentives and advantages including R&D tax credits and IP incentives that have encouraged clustering and investment from specific sectors.

We considered whether Westminster had the power to devolve Corporation Tax-varying discretion to the Northern Ireland Executive, and if it had, under what circumstances could this happen and what implications might flow. Our findings were:

To get the freedom to strike a sub-regional rate of Corporation Tax, Scotland must fulfil the conditions laid down in the Azores Judgement of the European Court. Under the 2006 ruling from the European Court of Justice, it was found national tax arrangements could be altered to meet sub-regional “specific characteristics,” if they met three criteria:

- the decision must be taken by a (sub-regional) authority with a political and administrative status constitutionally separate from the central government;

- the decision must be adopted without the central government being able to intervene in its content; and

- the financial consequences of a reduction in the national tax rate for undertakings in the sub-region must not be offset by aid or subsidies from other regions or central government.

If Westminster invokes the Azores Judgement, it could facilitate the Scottish Parliament to strike a regional rate of Corporation Tax. However, invoking the Azores Judgement may also confer on the sub-region (the Scottish Parliament) the ability to vary other taxes and not merely Corporation Tax and it is important to determine if Westminster and/or the EC concurs with this assessment.

However, under the terms of the Azores Judgement Scotland would have to bear the cost of any reduction in Corporation Tax (or any other tax it reduced) by way of a cut in the block grant. One official estimate is that, in 2007-08, some £3.465bn of CT emanated from Scotland\(^\text{18}\), representing around 8.6% of the total CT raised in the UK. However, this is merely one estimate and is may be subject to a variety of different interpretations. For example,
during the Northern Ireland review of the implications of reducing CT, the same question came up with a variety of different ‘official estimates’ ranging from £500-£600m\(^1\) to £841m\(^2\).

HMRC estimates\(^3\) that the combination of ‘direct’ and ‘behavioural’ effects of cutting corporation tax to 12.5% in Scotland would cost some £2.6bn annually.

As in the Northern Ireland debate, there is considerable uncertainty as to how this figure has been calculated and how much reliance can be placed on the estimates. In Northern Ireland the potential annual ‘cost’ (of reducing CT to 12.5%) varied between £225-£270m and £400m. The difference was attributed to; (a) uncertainty as to how much CT is actually raised (or accrued) in the region; and (b) the varying estimates of likely ‘direct’ and ‘behavioural’ effects of cutting corporation tax to 12.5%.

In addition to defining the quantum of Corporation Tax raised from qualifying undertakings operating in Scotland (as outlined above) the Scottish Government may have to make good further tax losses to Treasury, resulting from:

- Companies relocating from UK to exploit the (say) 12.5 percent Corporation Tax in Scotland;
- UK companies restructuring their activities so that a greater proportion of their profits arise in Scotland; and
- Tax motivated incorporation (TMI) where partnerships and sole traders already trading in Scotland incorporate to take advantage of low Corporation Tax, resulting in a fall in PAYE/NIC revenues.

If this debate is to move forward constructively, it is crucial to reach consensus on what constitutes a Scottish company, how much CT accrues from work done in Scotland and the long-term trend that this infers. Once that has been agreed, further consensus must be agreed on the ‘direct’ and ‘behavioural’ effects of reducing CT in Scotland.

A further complication (if we look to the Northern Ireland debate) might be the potential for Scotland to retain additional tax income that would accrue from the creation of additional employment directly attributable to new investment as a result of reducing CT. For example, the Northern Ireland Secretary of State has suggested that the region might retain PAYE & NIC contributions flowing from new employment created by a reduction in CT and, while this is not currently in the mainstream Scottish debate, it might emerge and would further complicate the process of tax collection.

In conclusion therefore, until the total level of CT accrued through work done in Scotland is defined, the likely cost to the block grant of devolving CT cannot be quantified. Likewise until the ability of the Scottish Government being able to retain ‘new’ taxes raised directly resulting from new investment is defined, future benefits cannot be quantified.

b. Proposal for the control of excise duty on alcohol and tobacco – risks and benefits

Noting our comments on the application of the Azores judgement above, it is in theory, feasible that excise duty could also be devolved to the Scottish Parliament. We note that the Scottish Government has stated\(^2\) that it wishes to gain control over these duties to tackle Scotland’s health problems, with the implication that it would seek to

\(^{19}\) Sir David Varney 2007, Review of tax policy in Northern Ireland.


\(^{21}\) HMRC, July 2011. Explanatory Note on estimating the cost of a reduction in the Corporation tax rate in Scotland, HMRC.

\(^{22}\) Alcohol etc. (Scotland) Bill, November 2009, Scottish Government.
impose higher rates of duty in order to achieve this objective. While this is a laudable initiative from a health policy perspective, it could lead to distortions and unintended consequences both in the behaviour of business and consumers as well as in the overall Scotland and UK tax framework itself.

From a fiscal point of view, while altering the duty rate is potentially more attractive to the Exchequer than the Scottish Government’s previous minimum pricing plans, there are risks attached to this. Given the products the devolved tax would cover, this could have a direct impact on the economy through: (a) companies potentially deciding that higher duty rates make Scotland a less attractive place to produce these products and moving production plants to elsewhere in the UK; or (b) through the creation of a grey economy (or black market) in goods which are subject to a lower rate of duty in the neighbouring nations of the UK.

It is plausible that, should the differential in price become significant, that Scottish consumers would resort to travelling to Belfast, Newcastle, Carlisle and Berwick to stock up on cheaper products. This could develop into a more widespread black market and would therefore necessitate an increase in the policing of such movements of goods. Border controls with England and Northern Ireland would need to be created to guard against the risk of loss of revenue.

Consideration would also have to be given as to whether alterations to the devolved tax would be anti-competitive under EU law. EU law currently states that there should be minimum rates for excise duties, but Member States decide the actual rates levied. Certainly, there would be likely to be challenges should differing rates be thought to be anti-competitive within a single Member State.

There would require to be a significant revision to the Holding and Movement regulations for these products and this again, would require specialist input from either a separate tax department within HMRC or a separate Scottish Tax collection agency. Issues such as the creation and operation of a separate Scottish bond warehouse system duty suspension regime and general administration would require to be addressed. This is not to say that the challenges of a higher rate of excise duty for certain products could not be met; rather, it is to highlight that these practicalities would, by definition, mean further costs of administration, both to the Scottish Government (and therefore taxpayers) as well as for business – which would inevitably be passed on to taxpayers.
4. AGL and APD – how might devolution of these taxes impact Scotland

About AGL
In 2006/2007, the amount of tax raised by the UK Government was £321 million. Of this, £50 million came from Scotland, representing 15% of the total AGL tax take. There is no basis for assuming that this percentage will fluctuate widely year on year. Consequently, it appears broadly reasonable to apply this percentage to the UK AGL tax take in the following years:

• 2008/2009 = £66.8 million
• 2009/2010 = £41.55 million

AGL could be devolved to the Scottish Parliament in a number of different ways. It could be “switched off” as is proposed with SDLT and LFT with the Scottish Parliament being given the power to design a replacement for it from scratch. Alternatively, the Scottish Parliament could be given control over the rate of tax only. A further extension of this would be to have the power to amend the tax base as well. Therefore the Scottish Parliament could, in theory, raise, exempt, lower, alter, abolish, redesignate, reclassify or redesign AGL.

However, if Westminster only gives the Scottish Parliament the power to increase or lower the rate of AGL in a similar manner to the proposed operation of the SIT, its power will be limited.

AGL is a potentially suitable tax for devolution as it is essentially an ‘immobile tax base’ and is less likely to cause significant economic disruptions than a tax which does not have an immobile tax base (e.g. VAT). It is useful to understand\(^{23}\) that 80% of AGL that is collected in the UK comes from just 7 companies. A further four or five companies account for 3%. Between 10 and 20 companies account for 1% of AGL and the remainder is collected from around 350 smaller companies whom produce small amounts.

AGL is therefore dependent on a very small number of companies and, from a devolved administration perspective, it would be necessary to identify the location of these companies’ extraction activities.

If the Scottish Parliament were given control of AGL, then there would be a direct link between the revenue raised and associated spending. The Scottish Parliament would also be able to spend the revenue raised based on relative need and/or socio-economic circumstances, which is something which is not currently considered in the block grant system.

To add to the uncertainty, it has been shown that the tax raised in Scotland is exceeded by direct Scottish spending. Consequently, the amount that the Scottish Government would receive from AGL directly may be less than the corresponding amount it would receive under the block grant. This again calls into question the nature of the block grant to the Scottish Government and would necessitate another amendment to this at the very least. However, as noted previously, it will also lead to the whole issue of funding for the devolved nations being placed under further scrutiny.

In the event that the control of AGL is transferred to Scotland then there will be additional compliance costs for both the Scottish Government (and therefore taxpayers) and businesses. It is difficult to quantify the cost of implementing the collection of a single tax as HMRC is currently responsible for collecting numerous taxes, so more work needs to be done in this area in order to establish the cost of such a change.

Due to the land border with England, consideration would have to be given to the cross border consequences of AGL powers being devolved to the Scottish Parliament. When AGL was

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\(^{23}\) Aggregates Levy [SN/BT/1196], February 2011, House of Commons.
introduced, there were specific problems in Northern Ireland due to its land border with the Republic of Ireland. This resulted in smuggling aggregates across the land border, an increase in imports of aggregates from RoI, and illegal sites being used to extract aggregates.

In order to combat this HMRC introduced the ‘Aggregates Levy Credit Scheme’, whereby operators in NI were eligible for an 80% refund of the AGL it had paid. The scheme was challenged at an EU level and was suspended in December 2010 as it was considered to be state aid. However, as of April 2011 legislation to allow immediate reinstatement of the Scheme was introduced, so that reinstatement can take place as soon as the EU Commission gives State Aid approval.

A similar situation could result in Scotland. If the Scottish Parliament were to drastically reduce the level of AGL in Scotland in order to encourage businesses to open sites in Scotland then this could have a detrimental impact on the industry in England; this could result in the AGL rates being reduced there – a potential “race to the bottom”. Any potential competitive edge for Scotland would be lost and both regions would then have lower AGL rates and therefore less revenue.

**About APD**

In 2006/2007, the amount of duty raised by the UK Government was £971 million. Of this, £94 million came from Scotland – around 9.6% of the total APD duty take. There is no basis for assuming that this percentage will fluctuate widely year on year under the current system, as it is fair and reasonable that any increase/decrease of flights taken in Scotland would be relatively consistent with the rest of the UK. However, there are clearly existing anomalies concerning the current range of destinations and numbers of long-haul flights available from Scottish airports.

Consequently, it appears broadly reasonable to apply this percentage to the UK APD tax take in the following years:

- 2008/2009 = £178.7 million
- 2009/2010 = £178.3 million

We believe that APD should be devolved to the Scottish Parliament for that Parliament to amend, reduce or abolish as it sees fit. Currently, there is no APD charged on flights departing from airports in the Highlands and Islands. Consequently, there are already different rates applied in different regions of the UK. If the power of APD was devolved to the Scottish Parliament, there should not be any conflict with EU law. The abolition of APD would benefit tourism and business with the cost potentially significantly offset by the reduction in compliance costs for both the Scottish Government (and therefore taxpayers) and businesses.