DEVOLUTION (FURTHER POWERS) COMMITTEE

AGENDA

4th Meeting, 2015 (Session 4)

Thursday 5 February 2015

The Committee will meet at 9.00 am in the David Livingstone Room (CR6).

1. **Decision on taking business in private:** The Committee will decide whether to take item 3 in private.

2. **Evidence on Taxation clauses:** The Committee will take evidence from—

   Charlotte Barbour, Head of Taxation (Private Clients & Small Businesses), ICAS;

   Professor Anton Muscatelli, Principal, University of Glasgow;

   Gwyneth Scholefield, Director, and Steve Couch, Partner, PricewaterhouseCoopers.

3. **Choice of Adviser (in private):** The Committee will consider a list of candidates for the posts of adviser.

   Stephen Imrie
   Clerk to the Devolution (Further Powers) Committee
   Room T3.40
   The Scottish Parliament
   Edinburgh
   Tel: 85206
   Email: devolutioncommittee@scottish.parliament.uk
The papers for this meeting are as follows—

Written Evidence from PricewaterhouseCoopers  DFP/S4/15/4/1

PRIVATE PAPER  DFP/S4/15/4/2 (P)
PricewaterhouseCoopers (PwC) submission to the Devolution (Further Powers) Committee – call for evidence

SESSION FEBRUARY 5TH 2015

Thank you for inviting us to give evidence to the committee in person on February 5th. We enclose below a brief summary of our comments on the draft clauses as issued by the UK Government in January. Our comments are focused on the practicalities of implementing the proposals and the clauses themselves. Questions of tax policy and wider funding questions remain unresolved at this stage.

Income Tax

The draft clauses involve changes to Scotland Act 1998 (essentially a rewrite of the new clauses in Scotland Act 2012) and also revisions to Income Tax Act 2007. As set out they will achieve the changes set out in the Smith Commission i.e. that the SG will have power to make a resolution setting the rates and bands that will apply to Scottish taxpayers receiving non-savings income.

The definition of savings income and of income tax generally and the level of the personal allowance will remain within the remit of the UK Government.

As above, the important question for the Scottish Government remains the impact on overall funding i.e. how will the planned indexation of income tax receipts and the consequent adjustment to the Block Grant work in practice.

Timing of the introduction of the new rules is not yet agreed and this is an ongoing concern for our clients who are starting to make plans to implement the changes already in Scotland Act 2012.

Other practical issues arising from implementation of the new rules remain much the same as those already identified for the Scottish Rate of Income Tax, for example:

- Who is a Scottish taxpayer? What constitutes a main residence? Guidance should be full and clear to help people comply with the rules.
- Employers will need to change payroll systems and consider the impact of PAYE settlement and Dispensation.
- Issues remain for charities and for pension providers as to identification of tax status of donors/contributors.

VAT

We note the extension of the Smith proposals to include VAT charged at the reduced rate in addition that charged at the standard rate. This is a sensible extension of the proposals and does not change the intention underlying the decision to assign such revenues back to Scotland.

The draft clauses set out the mechanical process by which the amounts will be allocated each year.
The key to implementation is obviously the agreement between Treasury and Scottish Ministers as to how to calculate ‘the amount attributable to Scotland for each period’ and how the adjustment to block grant will be calculated.

**Aggregates Levy**

The levy was identified by the Calman Commission as suitable for devolution and, absent the legal challenge, would already have been devolved. To delay the devolution pending the conclusion of the legal position is sensible at the moment.

Again, the draft clauses are mechanical and achieve their intention, which is to remove Scotland from the levy at some future date and give the Scottish Government the power to set up an equivalent tax should they wish to do so.

The important stage for Scotland will therefore be when the opportunity comes to develop the replacement tax.

**Air Passenger Duty**

As above, the draft clauses are mechanical and will, at a future agreed date, give effect to the agreement to disapply APD in Scotland (i.e. the tax will not apply to passengers boarding aircraft on Scottish airports). A Scottish version of APD could then be applied from that date (if so desired).

**Revenue Scotland**

Both APD and Aggregates levy are categorised as ‘devolved taxes’. They will therefore be administered by Revenue Scotland and will fall within the newly-developed regime as set out in the Revenue Scotland and Tax Powers Act 2014. In due course, the Act and supporting secondary legislation will need to be revisited to ensure that it deals appropriately with the new taxes. Deadlines and governance regimes that currently exist will need to be adapted. The underlying principles set out in the Act and also in the draft Charter will presumably continue to underpin the tax administration of all devolved taxes.

Revenue Scotland will need time to ensure that it has sufficient, suitably-trained staff to administer the new taxes. This should be a factor in agreeing timing for the transfer of powers.
PricewaterhouseCoopers (PwC) submission to the Smith Commission on increasing the powers of the Scottish parliament

The Commission comes at a critical time for Scotland. Fundamental questions about the constitutional future of the country were raised during the referendum period, and with them, public expectations about the ability of Government (at all levels) to make a more meaningful difference to people’s lives. Whilst our response focusses on the further devolution of powers, especially fiscal powers, much of the change that will prove most meaningful to the people of Scotland as well as the rest of the UK cannot be driven solely by central or even regional governments. The issue is about much more than the division of powers between the UK and Scottish Parliaments. It raises questions of responsibility and accountability, and who is best placed to use the extensive powers of the State to improve the economic and social wellbeing of the citizens of the UK as a whole, whilst addressing the specific needs of the regions.

PwC believes that it is well qualified to offer authoritative, constructive and independent comment to this debate. We have been significant contributors to the debates on devolution and decentralisation in Northern Ireland, Wales, Scotland and England and have engaged with our wide-ranging client base to understand and assess its potential impact.

As a business with 17,000 people across the UK, we see critical issues for us and our clients in creating the right environment that stimulates investment while maintaining a high degree of stability, certainty and investor confidence.

Our views on expectations of government have been extensively informed by the Citizens’ Juries that we have held over the past few years. These are forums where groups of individuals or businesses are given the opportunity to discuss aspects of taxation and spending with experts and hence to develop an informed view on policy priorities. Key themes that have emerged from several Citizens’ Juries undertaken since 2011 (including a Scottish Jury’s submission as evidence to The Christie Commission) are a desire that:

- Governments be clearer and more specific about the objectives of tax policies;
- a longer term approach to policy is taken, to improve stability and growth; and
- more is done to educate the general public about the purposes and limitations of tax policies, including the trade-off between perceived fairness and simplicity.

In this submission we have drawn together and crystallised the results of our research and engagement, and have summarised some of the issues facing our clients.
Conclusions

- Transparency and simplicity should be key principles governing taxation policy at any level. Creating additional administrative burdens should be avoided wherever possible.

- For reasons of legality and practicality, certain taxes are not suitable for devolution. In this category, we include National Insurance contributions (NIC), VAT, Capital Gains Tax (CGT), Inheritance Tax (IHT), excise duties, betting and gaming taxes, alcohol and tobacco duties and Corporation Tax (CT).

- The considerable costs to UK businesses of devolving corporation tax should not be underestimated and could impose a disproportionate burden on SMEs.

- Devolving the power to set and vary the rate of CT in Scotland would be at best a blunt – and likely costly - instrument. While experience of other nations suggests that a lower rate of CT can contribute to the attractiveness of a region as part of a package of other incentives, there is also a risk of damaging tax competition and there is no clear evidence of a simple correlation between low CT rates and high levels of foreign investment. Further consideration should be given to ways of adapting the current provisions to give greater flexibility to policy-makers in Scotland.

- The tax most suitable for devolution is income tax, but we have concluded that partial devolution (e.g. over rates and bands) would balance the benefits of accountability with the need to maintain the UK-wide market for financial services whilst not overburdening businesses and individuals with complexity.

- Assigning tax revenues (as an alternative to devolution) may seem an attractive compromise. Our concern is that this would increase both administrative complexity and exposure to tax volatility without any commensurate increase in the direct control of the Scottish Parliament over revenue-raising. Accountability would not be enhanced.

- The impact of devolution on the overall funding position under the Barnett formula should be considered.

- The devolution of APD is both feasible and desirable for reasons given late in this submission.

- Increased borrowing powers are likely to be necessary following further fiscal devolution. Consideration should be given to devolving those borrowing powers to a local level (e.g. to key cities).
• Whilst devolution of locally-delivered welfare spending would be beneficial, wholesale devolution of all welfare spending including pensions is not, in our opinion, advisable.

• The oil and gas and financial services sectors are vital to the Scottish economy and their continued success should not be undermined by changes to the tax system.

Principles underlying devolution

In common with Scotland’s business organisations, and with the Scottish Government’s Statement of Purpose\textsuperscript{1} we agree that sustainable economic growth should be a guiding principle. Our view on what constitutes sustainable economic growth is guided by the type of growth that citizens value, which may differ from, but complement, Government’s focus. In the eyes of the public, future ‘good growth’ relies on jobs and income as well as health, work-life balance and housing. In general terms, economic measures of GDP and Gross Value Added (GVA) growth are secondary considerations to the public.

Devolution should not be driven by short-term political considerations, but instead be part of a considered approach to the UK’s fiscal and spending arrangements, with due weight given to the impact on all parts of the UK.

Our Citizens’ Jury research consistently indicates that the current allocation of powers and the issues of managing the fiscal deficit are widely misunderstood and that when citizens are better informed, their views on such matters alter significantly. Consequently, the debate should not be solely focused on where powers reside. Further devolution of powers should also be accompanied by higher levels of transparency and clarity in the explanation of how these powers are used.

A governing body that spends public money should be accountable for raising at least some of it. Currently the balance of accountability in the Scottish parliament is heavily on the side of spending powers rather than revenue-raising. The opportunity to increase accountability is also primarily an opportunity to improve the flexibility of the current system and enable policies to be put in place that can enhance the economy and society of Scotland.

A further important principle is that devolved taxes should not substantially distort national or sub-regional behaviours, nor impose significant additional administrative burdens on either central or regional governments – or on the businesses and individuals who will pay and collect those taxes. It is important to assess and understand the practical issues associated with devolution of powers, ranging from legality of devolution under EU Law to the cost and practicality of implementation.

Any significant devolution of tax varying powers will have consequences in respect of the block grant and whilst we note that the current Government has not proposed any changes to the current (Barnett funding) formula, that position may not be sustainable in the longer term. More consideration should be given to the implications of devolving tax-varying powers on the block grant and on any future modifications to Barnett, and this should be a
priority. Whilst this is not within the remit of the Commission, we are concerned this may have unintended consequences if not factored into the overall policy for further devolution, particularly around aspects of welfare reform.

Revenue-raising powers: borrowing and taxation

Borrowing and Scottish Bonds

The Scotland Act 2012 has given the Scottish Government power to borrow up to a total of £2.2bn for capital investment. There is also provision for additional borrowing for current spending to manage fluctuations in tax revenues. This is limited to £200m p.a. up to an overall limit of £500m, but might well need to be extended to reflect the greater exposure of the Scottish Government to tax receipt volatility if further tax raising powers are devolved.

Capital investment borrowing powers allow the Scottish Government to borrow to extend investment capacity by up to 10% of its annual capital budget (subject to the limit of £2.2bn). We believe, consistent with recent findings of the City Growth Commission in England, that investment powers should be more locally devolved (e.g. to cities or regions). In coordination with greater local empowerment this will help to drive social and economic growth. This would enable decision making on allocation between current spending and capital investment (and the cost of servicing related borrowings) to be focused on local need and priorities.

A review of borrowing powers should be undertaken to establish the appropriate level of further borrowing powers, the appropriate balance between national, devolved and local powers, and the wider implications of further devolving this aspect of fiscal responsibility. It should bring into consideration the whole spectrum of Government borrowing and investment in Scotland, including the powers of cities to invest and to service borrowing from the proceeds of growth. We believe that the form of borrowing, whether from government sources or bond funding in the capital markets, should be determined by the borrower.

Taxation

The Holtham Commission identified six criteria to be applied when assessing whether a tax is potentially suitable for devolution, and we consider that these are an excellent starting point for such discussions. Those criteria are that a devolved tax will:

(1) promote accountability because the tax is highly visible, well-understood and raises substantial revenue;

(2) not harm administrative efficiency, because devolution does not alter economic behaviour to create inefficiencies or distort the economic relationships between regions of the UK;
(3) not harm administrative efficiency because it does not impose a substantial compliance burden on citizens and businesses, nor impose relatively high costs of administering collection (especially as a % of revenue raised);

(4) be relevant to policy in terms of providing a useful policy lever and helping to achieve the goals of the devolved government;

(5) be compatible with legal constraints (notably EU law); and

(6) have minimal impact on the tax base of the rest of the UK.

Whilst parties and organisations may give different weight to these criteria (and no one tax will probably fulfil all six conditions), they enable us to make an objective assessment of the current proposals.

Where devolution of a specific tax is not possible or practical, it has been suggested that revenues from that tax could be assigned to the Scottish Parliament as an alternative. There has been very little discussion of how this might work in practice but it does not, to us, seem an attractive alternative. Assignment of revenues, for example of VAT or corporation tax, would require additional layers of information gathering and allocation of income, profits or turnover. The Scottish Government would receive revenues from tax streams rather than direct from central government, and would therefore bear the risk of any fluctuations or falls in that revenue, whilst having no direct influence on the setting or collection of the tax. Their policies would only have an indirect influence on the level of the tax. For example, if consumption of certain good or services increased in Scotland, VAT paid by Scottish consumers would rise and hence the revenues flowing to the Scottish Government. This would do little to enhance accountability, as so many other factors would influence the level of tax raised.

VAT

It has been noted many times that VAT cannot be devolved within a territory as this contravenes EU law. Assignment of VAT revenues has been suggested as a solution which would provide accountability within UK law. Given that VAT makes up a large (approximately 20%) part of Scottish and UK tax revenues, this would be a significant undertaking and the administrative burden will need to be considered.

Given the above, we have concluded that assignment of VAT revenues would not achieve key objectives.

Excise duties

We would agree with the generally accepted premise that devolution of some taxes such as excise duties and tobacco and alcohol duties would be vulnerable to evasion to an unacceptable extent. Whilst these taxes are highly relevant as policy levers, the distortions arising from devolution would be considerable.
Air passenger duty

We considered the devolution of air passenger duty (APD) to Northern Ireland in December 2011, and we would regard it as a tax which is appropriate for devolution in Scotland beyond the existing exemption already afforded to airports in the Highlands and Islands. APD was identified by the Calman Commission as suitable due to both the relative ease of administration and the potential economic benefits, and this position is reflected in many of the submissions to the Smith Commission.

Our wider report on APD, the *Economic Impact of Air Passenger Duty* (February 2013) concluded that the abolition of APD across the UK could provide a short-term GDP boost of around 0.45% in the first 12 months, stabilising at around 0.3% per annum thereafter and increasing the UK economy by some £16 billion in the three years following. On this basis Scotland could expect to benefit from a pro-rate rate of economic growth.

National Insurance Contributions (NICs)

National Insurance receipts contribute about 18% of tax revenues and so would, particularly in combination with income tax, make a significant difference to the revenue-raising powers of the Scottish Parliament. As noted by others, contributory benefits and welfare spending are closely linked to NICs, although the link between welfare and NICs is not as direct as it once was. There are, however issues of feasibility around devolving NICs that make it less attractive for devolution, such as funding pensions. The issue of devolution of welfare spending is discussed below and is integral to any discussion on devolution of National Insurance. Hence we have concluded that devolution of NICs is not appropriate.

Capital gains tax (CGT) and Inheritance tax (IHT)

Together these taxes contribute approximately 1.2% of tax revenues. They are paid by a very small number of people and can be seen as complex the general population. As such, they do not immediately appear good candidates for devolution.

A further consideration is the impact that devolution might have on the market for financial products and services. Financial products that are commonly used for savings and investment (such as pensions, ISAs, and life insurance policies) are all based on the UK regime for CGT and IHT, and if Scottish taxes on such products were to diverge this could have a detrimental effect on access to the wider UK market that Scottish people currently enjoy. The reality is that Scottish taxpayers would be a relatively small market for such products compared to the rest of the UK, and providers would make decisions on a commercial basis as to how much they would be willing to invest in servicing that market. We have therefore concluded that any policy benefits or increase in accountability would be minimal compared to the practical disadvantages, and hence believe that these taxes are not suitable for devolution.
Corporation tax (CT)

The scope to devolve CT (or the power to vary the rate of CT) would be strictly governed by an exemption to the general EU regulation forbidding sub-regional tax variation. Based on that exemption (the “Azores Judgement”), a state can reduce the headline rate of CT in sub-regions only if certain conditions around the constitutional arrangements and financial consequences of the devolution are met.

Under the Azores Judgement, the UK Government could legally devolve the power to set and vary the CT rate to Scotland. The Scottish Government would be required to extend any reduced rate to all entities incorporated in Scotland. In addition, the revenues ‘lost’ to the UK Government by virtue of Scottish Government reducing the headline rate (including the ‘loss’ incurred were English entities to relocate to Scotland to enjoy a lower rate of CT) would be deducted from the block grant.

Devolution of CT is therefore legal under EU law provided that the conditions are met, but the cost and complications associated with such a change, including compliance costs to business, must not be underestimated. Full devolution of CT will result in a considerable burden for businesses operating on both sides of the border as profits will need to be allocated between Scotland and the rest of the UK and they will need to comply with two sets of diverging rules. Giving powers to the Scottish Parliament to target incentives and reliefs within Scotland (subject to EU issues such as State Aid) would potentially have more benefit that either devolution of the headline rate of tax or full devolution of CT. It would minimise administrative issues and potential distortion of behaviours whilst enabling the Scottish Parliament to refine the UK system to suit the Scottish economic environment.

For example, tax incentives for start-up businesses, SMEs and entrepreneurs play an important part in support for new businesses which are one of the key drivers to new job creation. These are provided not only through CT (e.g. research and development tax credits, NIC exemption for new companies employing fewer than ten people) but also CGT (rollover relief, EIS relief) and IHT (business property relief). These incentives are sometime of far greater importance to businesses than the headline rate of tax.

Whilst a competitive level of CT is desirable to ensure Scottish competitiveness, there is no clear evidence of a simple correlation between a low rate of CT, and increased levels of high-value foreign investment and indigenous entrepreneurial activity. An overriding issue for businesses is the stability and administrative simplicity of any CT regime. For all but the most localised organisations, any devolution measure could undermine that position.

Tax is just one of the many factors affecting the choice of business location. Where tax does influence investment, issues are considerably more complex than the headline CT 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 company may have to pay in the host country.
Income tax (IT)

Proposals to the Commission to date include extending the powers of the Scottish Parliament over income tax beyond those currently included in the Scotland Act 2012. Further devolution, including the power to adjust rates and bands, would potentially enable a more flexible use of this taxation power to have a more nuanced effect on the Scottish economy. However, the impact of changes in income tax on economic growth and job creation is unclear, and must be balanced against the greater complexity for individuals and businesses that will inevitably arise. There is also potential to distort other drivers of competitiveness, and to encourage cross-boundary migration by individuals seeking to minimise their personal liability.

We consider that devolution of personal taxation should maintain the current UK-wide market for financial services products. The products and services offered by financial institutions across the UK are designed for the UK tax and regulatory environment, and the advantages of this to Scottish savers, borrowers and investors are manifold. Given that this sector is such an important part of the Scottish economy, we believe that fiscal devolution which could undermine it would be counter-productive.

Our conclusion is that there is scope for devolving further elements of IT (over and above the Scotland Act 2012) whilst maintaining the integrity of the UK system and not distorting economic behaviour and creating burdensome costs. Full devolution over income tax would create such distortions.

Sectoral issues

Oil and gas and financial services are sectors of vital importance to the Scottish economy. We have noted above how important the seamless UK market is to the strength of the financial services sector and we would also stress that the robust and well-respected regulatory regime across the UK that enables businesses to operate in a seamless market is of equal importance. Devolution of regulation would create additional costs with no apparent enhancement to consumer protection.

Oil and gas companies are, of course, closely following the fiscal review that is currently underway, with submissions recently being made to HM Treasury. A separate tax code for Scotland may introduce more complexity for both government and business. Tax has an important part to play in the future health of the UK oil and gas industry by ensuring that investors can have confidence in their investments. The regime needs to be predictable for an industry that requires investment for the long term, and it also needs to be flexible enough to adapt to the significant change in the economics of what is now a mature and high-cost oil region. Oil and gas production occurs outside Scotland as well as within it, as does much of the activity that supports the oil industry. Like all corporate taxes, to subdivide the activities that take place within the UK is complex, particularly in relation to the very significant tax refunds that will be due in respect of decommissioning.
Spending powers

Welfare spending is a significant proportion of government expenditure across the UK and around half the population (of both the UK overall and Scotland) receive some form of tax credit or social security benefit. We would welcome changes that enable welfare provision to be delivered at a more local level with greater flexibility. Some aspects of welfare provision are better suited to this than others, and the examples put forward in other proposals such as the attendance allowance and the work programme would be good candidates for this approach.

In general, the state pension and the social security systems provide a means for the UK to pool risk and to promote social cohesion. At present, the argument that larger scale devolution of these benefits would be in the interests of the UK population as a whole (including Scotland) has not been convincingly made.

Conclusions

As noted above, there are challenges in devolving many of the existing taxes as these are integrated into the wider fiscal and spending arrangements. The tax most suitable for further devolution is income tax.

Devolution of powers should only be implemented where there is clear evidence that it will fulfil agreed policy objectives, such as attracting greater numbers of high-value foreign direct investment (FDI), 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.

It is clear that for Scotland to thrive, economically and socially, progress will be needed on a wide range of other issues which lie beyond the direct control of government - either in Whitehall, Holyrood, or locally. Whatever new settlement on powers the Commission arrives at, this will not alone determine Scotland’s ability to fully capitalise on its many strengths and opportunities.

Of fundamental importance is the evolution of local systems to support good growth, which frequently rely on changing individual and organisational outlooks and approaches, and which have much less to do with powers, than with personal levels of confidence, openness, and ambition. The willingness and ability to form partnerships and public-private collaborations, for example, feature as consistently important themes in multiple reports, commissions and surveys. To the extent that the Scottish Government already has many powers within its remit, these can be brought to bear to support the evolution noted above without relying on an expansion in formal powers devolved from the UK.
"The Purpose of the Scottish Government is to focus Government and public services on creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth."  
http://www.scotland.gov.uk/About/Performance/scotPerforms


iii Helping Economic Take Off: Devolving Air Passenger Duty (December 2011)

iv ECJ Case in 2006 on corporation tax in the Azores, an autonomous region of Portugal. Judgement summary reference ECLI:EU:C:2006:511 (Case no. C-88/03)