

Response to call for written evidence on the Scotland Bill 2010 and relevant legislative consent memoranda

9 September 2011

ABOUT ICAEW SCOTLAND

The ICAEW Members in Scotland (ICAEW Scotland) welcome the opportunity to respond to the call for written evidence on the Scotland Bill 2011 and relevant legislative consent memoranda. ICAEW Scotland serves over 1400 ICAEW members across the private and public sectors in Scotland and represents the views of ICAEW members who work in Scotland for national and international organisations. Across the UK, ICAEW members' expertise and experience is fed into the corporate strategy of the Institute to help form and influence policy.

ICAEW operates under a Royal Charter, working in the public interest. The regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world-leading professional accountancy body, the ICAEW provides leadership and practical support to over 136,000 members in more than 160 countries. Strengthened by the expertise of our whole membership, particularly those in the UK/EU who are interacting with government and institutions on similar economic issues, ICAEW is working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

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Introduction

In our previous **Scotland Bill 2010 call for evidence response document**, submitted in January 2011, ICAEW members in Scotland identified several concerns with the proposals:

- Limited tax raising powers could result in:
 - Inability to cope with economic fluctuations
 - Ineffective stimulus for Scottish Economy
 - Financial risk being too high

We are pleased to note some progress in these areas and are pleased to submit our responses to your call for written evidence.

The Scotland Bill has implications for Scottish, UK and global economies and the interaction and sustainability of these future economies. The comments we make reflect our members' views and the impacts concerning both Scotland and globally.

OUR RESPONSE TO KEY QUESTIONS

We have chosen to respond to questions 1 - 5, as set out in the committee's call for written evidence.

Question 1

You asked:

In its report, the Session 3 Committee supported the general principles of the Bill but recommended several amendments to strengthen it. What are your views on these proposals in general terms?

In our previous response, we stated that the work of the Calman Commission and the publication of the Bill were the first steps of a long journey which could lead to enhanced financial accountability for the Parliament and Government in Scotland. We understand the desire for wider tax-varying powers for the Scottish Parliament to recognise the different social, political, geographical and economic circumstances faced by Scotland and by businesses operating in Scotland. Ultimately, the granting of such powers are major policy questions for Parliament to decide.

As we said previously, limited tax-raising powers may not enable the country to cater for varying economic circumstances. We re-iterate these points in our current submission. Although the amendments have sought to improve on these concerns the current proposals remain restrictive and do not consider fully the interaction with the UK economy and taxes, or the global economy in which Scotland operates.

A broad based taxation system would provide the benefits of increased flexibility and responsiveness to economic developments.

However, whatever the potential benefits of enhanced financial accountability in terms of the Scottish economy, it needs to be recognised that potentially serious, expensive, complicated and unintended consequences may arise as a result of changes to the Scottish tax system. The proposals may result in more complexity within the UK infrastructure and this raises concerns about the capacity of HMRC – an organisation that is already under severe budgetary pressure and which is in the throes of yet further restructuring. Changes to taxation as a result of the Scotland Bill would add further complexities and practical collection issues which may result in overall costs being disproportionate to the potential benefits.

ICAEW's Tax Faculty has developed Ten Tenets for a Better Tax System. Full details of our Ten Tenets for a Better Tax System are attached as an appendix. Our core principles are that tax should be certain, simple, and easy to collect and calculate. We advocate simplicity in tax systems as a basic core element to aid understanding, compliance and avoid unnecessary costs.

When measured against these principles we are concerned that the current proposals on tax-varying powers lack clarity and substance, while potentially increasing complexity and burdensome red tape without a clearly demonstrable improvement in Scotland's economy and growth prospects.

Question 2

You asked:

What are your views on the amendments that were then made to the Bill during the Committee stage at the House of Commons subsequent to the report of the Session 3 Committee?

The fact that the Scottish Government will not have to absorb the first £125 million of any forecasting variations is welcome.

However, the question remains, without wider tax-varying powers, will the Scottish Government be able to respond adequately to future changes in economic circumstances?

To be able to respond, it may be more appropriate for the Scottish Parliament to be fully accountable for the effects of its own tax policies and the impact of any forecasting variations and to be given the power to make any necessary adjustments and plans. To forecast and identify potential shortfalls is a start. To be able to react accordingly is vital.

The principle of the 'Scottish Cash Reserve' is sound although the limit of £125m over a five year period (£25m a year) is low in Government spending terms.

Given that forecast variations could go either way we think it would be reasonable to also operate the equivalent of an overdraft facility rather than, as currently proposed, having to build up a reserve in advance.

Question 3

You asked:

What is your view on the Bill's borrowing proposals subsequent to the UK Government amendments?

In ICAEW Scotland's previous response, on the topic of borrowing, we stated we had questions and concerns over the proposed new borrowing powers. The amendments have not allayed these concerns.

Prudent financial management would be crucial in balancing repayment requirements – we must remember that spending in one year has to be balanced out with reductions in subsequent years.

For significant capital projects, the maximum sums to be borrowed as permitted in the Scotland Bill could be inadequate.

Increased borrowing powers may provide local investment flexibility. We would suggest when forming a policy on borrowing, the Scottish Government should follow best practice internationally, including of course consideration to EU guidelines.

We would recommend that detailed examination of the finances of any borrowing moves are weighed against the benefits accruing when considering borrowing powers policies.

In all these deliberations, we believe it is important that transparency and clarity in financial information is paramount. Better Information will allow markets to deliver better outcomes that will benefit society as a whole. Stakeholders and the public need to be confident at the outset that achievement of growth, enterprise, sustainability and well managed public finances can be described and measured in a meaningful and transparent way.

We believe that there is a compelling need to identify the necessary relevant, reliable, timely market information and its delivery mechanism to meet this need.

Question 4

You asked:

The Scotland Bill proposes a Scottish income tax derived from reducing the UK rates by 10 pence and giving the Scottish Parliament the power to add a fixed amount on to each of the basic, higher and additional rates. The block grant will be reduced to accommodate for these tax-raising powers, by an as yet unspecified mechanism. What do you think the effect of these proposals will be on (a) the finances of the Scottish Parliament and its ability to fund public services and (b) the ability of the Scottish Government to stimulate economic growth?

Our members' views remain similar to our previous submission on the Scotland Bill 2010. In a previous response to a similar question asking for our view on substituting the revenue from taxes levied by the Scottish Parliament for some of the block grant, ICAEW Scotland stated:

On the face of it, since the amount of devolved tax revenues will be exactly equal to the amount by which the grant is reduced, this appears to be a fair arrangement, allowing the Scottish Government planning opportunities to stimulate the economy by varying this rate, which is the task facing any Chancellor in using the tax lever to boost the economy.

However, as highlighted in our answer to question 1 above, should economic circumstances vary there is no scope for making good a shortfall. In addition, the proposed application of a proportional formula is problematic and likely to have perverse results in that if the Scottish rate of income tax is reduced below 10%, a larger proportion of any resulting growth would be allocated to the non-Scottish income tax rate, thus reducing the benefit to Scotland of any reduction. Conversely, increasing the Scottish rate would result in a greater proportion of income allocated to Scotland. In short, such an approach could have the opposite effect to that intended.

We also question whether the full extent of migration has been considered, both inward and outward. In the current fragile economy, significant variations in tax liabilities may affect taxpayers' choices and this will impact not only the tax monies raised but also the demands and costs of public services.

A major practical concern that has been expressed by many parties is the identification of a Scottish resident. We believe that it is important that this test needs to be clear, simple and yet effective, but not at the cost of being excessively cumbersome to operate. In a modern global economy there are a significant number of taxpayers who are multi-locational based or are able to work in a different location to their employer.

It would seem logical to work to the same new rules of UK residency to determine liability to Scottish Income Tax.

We welcome a clear simple system which considers registered addresses and economic activity. Taxpayers and organisations must be able to identify with clarity and ease who is a

Scottish taxpayer. We suggest a self-declaration box could be included on annual PAYE and Self Assessment Tax Returns with accompanying guidance to help taxpayers.

However, this may well result in a significantly higher number of individuals having to file tax returns. The burden will not just impact upon taxpayers but will also fall upon HMRC. HMRC are significantly reducing their staffing levels and have been failing to reach acceptable service levels. We have concerns over how the organisation can cope with the added task of collecting and accounting for different Scottish tax rates.

Transitional arrangements and training will be required for taxpayers and HMRC to manage migration from existing UK taxation arrangements to Scottish focused collection. The Scotland Bill Committee accepts that the costs of collecting Scottish tax revenues should fall to the Scottish economy. Attention and transparency must be applied to the quantification of this cost.

Question 5

You asked:

The Scottish Government has stated its desire for greater taxation powers. What is your opinion on:

the proposal for the control of corporation tax and how may it impact the Scottish economy and Scottish public finances?

the proposal for the control of excise duty on alcohol and tobacco and what may be the risks and benefits?

the practical challenges that may arise in implementing these taxation changes?

Our response focuses on corporation tax rather than on the more sector-specific alcohol and tobacco duty.

In our previous response we suggested that a situation where Scotland can only introduce new taxes without reducing existing taxes such as Corporation Tax and NI would lead to higher taxation in Scotland than the rest of the UK – a situation which should be avoided. We re-iterate this point in this submission.

Corporation tax powers as part of the wider control of the taxation system could provide flexibility for Scottish Ministers to respond to changing economic circumstances. The current debate appears to be focused mainly on rates (mainly rate reduction) on the one hand and potential corporation tax migration from/to other parts of the UK.

The ICAEW Tax Faculty recently responded to the HM Treasury consultation document *Rebalancing the Northern Ireland Economy*. In this response, we set out some key issues including the need for simplicity, the implications of having more than one corporation tax system in the UK, the need for a detailed cost benefit analysis, and the implications for HMRC, as well as looking at alternative mechanisms and policy options that might work in Northern Ireland. The Committee may find it useful to read our document, and it is attached as an appendix.

With regard to the Scotland Bill Committee's call for written evidence, our members raised concerns regarding factors including:

- Whether there is sufficient scale and diversity within Scottish corporate organisations to maintain stability particularly within the current economy;
- The current level of committed Government expenditure;
- Competition within the UK to cut rates further;

- Risk of reduced rates stimulating profit extraction rather than the growth the policy desires;
- Lack of clarity over the definition of a 'Scottish' company and the administrative burden for companies (as for Income Tax) operating in many national locations;
- HMRC workload to cope with these changes in the face of continuing staff reductions.

Given the lack of evidence concerning existing sources of corporation tax take in Scotland – we note estimates are based on Scottish activity – it is difficult to comment on whether the current tax base (by firm, firm size and type of industry) has sufficient scale and diversity to maintain stability over the cycle.

The UK, which as a whole is an open market economy more than 10 times the size of Scotland, has struggled to cope with the loss of corporation tax revenues from the banking and financial services sectors. A devolved Scottish corporation tax take would have suffered even more, proportionally.

Corporation tax is more volatile than other taxes such as VAT or income tax, especially during the downside of the economic cycle. It would be very important to ensure that the tax base is sufficiently diverse to cope, otherwise the overall total Government budget would be at risk of unexpected deficit.

The 'Irish Miracle' is often cited to promote a low corporation tax regime as a generator of economic growth. Proponents are often unaware of Ireland's unique economic history which allowed their policies to be successful. At the end of the 1980s, prior to the economic boom which saw Ireland move from an agriculturally dependent economy to a modern service based economy, Government spending was low per capita (emigration helped to reduce the burden of unemployment and the cost of other services).

Over the next 25 years, Ireland was able to grow its economy through inward investment and at the same time grow its government spending in line with its economic development. This allowed status quo spending to be financed by existing government revenues, with real growth in net revenues coming from the growing corporate worth in Ireland (until the Government took on its Banks Debts).

In contrast Scotland has been an industrialised country for over a century. Government spending in areas such as education, infrastructure and health is all committed so unlike Ireland, there is an existing dependency on Corporation Tax at current levels. The impact of this is that a reduction in corporation tax rates in Scotland will reduce the annual yield whilst waiting for new businesses to register as 'Scottish' and this shortfall will have to be met (both in the short and long-term) by some other source of funding.

If this alternative funding is sought through increases in other taxes such as income tax, VAT or excise duties, this provides a significant risk to domestic consumption and economic growth (note for example the current impact of UK Government tax increases) that can undermine any theoretical benefits from corporation tax rate reductions.

The debate on corporation tax rates tends to focus on the success of Ireland's 12.5% and the possibility of tax tourism highlighted by WPP's move to Dublin in 2008 to avoid increased UK taxes. It is unlikely that a 12.5% rate is achievable in Scotland, or for that matter by Northern Ireland, without significant subsidy from the UK Government due to existing expenditure patterns. In addition, the already announced reduction in UK Corporation Tax Rates from 28% to 24% over the next 4 years means that Scotland, to generate economic activity, would need to take a substantial gamble on a corporation tax reduction generating an increased yield in the medium to longer term, to compensate a reduced corporation tax take in the short term.

A more fundamental problem is that a policy of pursuing corporation tax reduction can, as the committee recognises, become a race to the bottom that in the end is unsustainable and does not deliver long-term business investment. It is interesting in this context to note that

WPP are planning to return their corporate HQ to the UK in 2012 after less than 5 years in Dublin.

We would raise concerns that there could be no real benefit to Scotland if other taxes have to be raised on residents to cover the shortfall of such transfers. Perhaps it would be preferable to examine tax incentives that could be focused on activities that will specifically support investment in Scotland.

Clarity will be required for companies with dual residence status and guidelines as to the allocation of profits between branches of companies operating across the UK.

Transfer pricing is already a complex area for companies trading outwith the UK, a situation of varied CT rates within the UK will increase the complexities of an already complex area. Whether the benefits of a reduced rate will outweigh increased complexity and costs is, at this stage, far from clear.

Our members also reported concerns that whilst any of the further measures to devolve tax varying power to the Scottish parliament could potentially improve economic growth, this would be subject to the measures being used judiciously.

LIST OF APPENDICES – also available at www.icaew.com

1. ICAEW TAX FACULTY 10 TENETS FOR A BETTER TAX SYSTEM
2. ICAEW TAX FACULTY TAX REPRESENTATION: REBALANCING THE NORTHERN IRELAND ECONOMY

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