



SCOTLAND

## **Feedback on the Scottish Parliament's Economy, Energy and Tourism Committee Inquiry into Scotland's Economic Future Post-2014**

### **Introductory Comments**

ICAEW welcomes the opportunity to comment on this important and wide-ranging Economy, Energy and Tourism Committee inquiry.

Independence in Scotland is ultimately a political question and as such will be decided by the Scottish people. ICAEW is an apolitical organisation so we have focused our response on the possible economic implications and technical challenges associated with Scotland's constitutional options, based on the proposals contained in the Scottish Government's White Paper, *Scotland's Future*.

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31 January 2014

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## ABOUT ICAEW

1. ICAEW is an international body based in the UK and 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.
2. As a world-leading professional accountancy body, ICAEW provides leadership and practical support to over 140,000 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.
3. We believe in acting responsibly, in the best interests of our members and the general public. We act with integrity, creating effective partnerships with organisations and communities worldwide to ensure the highest technical, professional and ethical standards.
4. ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
5. 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. ICAEW ensures these skills are constantly developed, recognised and valued.
6. 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 local, national and international organisations.

## OUR RESPONSE

### Scotland's Public Finances – General Comments

7. In terms of the financial details provided in the white paper, and particularly in Annex C: Scotland's Public Finances, we feel that many questions remain unanswered. Many of those voting on 18 September may wish to see an 'opening balance sheet' presentation incorporating allocations of UK-wide assets including natural resources and of liabilities, for example pension liabilities and national debt. We feel that the presentation used, which switches between percentages of GDP and £ billions is rather confusing.
8. The white paper uses figures for tax revenues and public expenditure that, although they may be the best available, are not robust because they are based on estimates and limited data. For instance, according to the paper "Devolving Corporation Tax in the Scotland Bill" prepared by the Scottish Government in September 2011, "There are no separately collected figures on the amount of corporation tax raised in Scotland. Figures compiled by HMRC are not disaggregated below the UK level."
9. Similarly, the Fiscal Commission Working Group's First Report – Macroeconomic Framework, notes at Chapter 8.16 "As GERS [Government Expenditure & Revenue Scotland] takes the current constitutional framework as given, it is limited in what it can and cannot say about independence. Post-independence, not only will the fundamental structures of the Scottish economy (such as economic incentives and expectations) be subject to change, but the basic tax and spending choices of an independent nation may also differ. In addition, particular expenditure commitments - such as debt interest payments – may be subject to negotiation." The Report does though state, at 8.17, that "It [GERS] does however provide a useful indication of the relative strength of the public finances under the current framework and a starting point for discussions of Scotland's fiscal position."
10. In 2013, ICAEW published a report entitled *A CFO at the cabinet table? Strengthening UK Government finances for the future*. This publication suggests that the voice of finance needs to be taken more seriously in government and that without a long-term public finance strategy informed by financial information, the UK (and potentially an increasingly-devolved or independent Scottish Government) could exacerbate an already difficult period of economic instability and uncertainty. The report, which includes a case study from New Zealand and a light-hearted 'job advert' for a Group CFO within Government, calls on politicians to accelerate financial discipline in Government and create a Group Chief Financial Officer (CFO) role to take overall responsibility for financial disciplines across government. *A CFO at the cabinet table?* Can be downloaded from <http://www.icaew.com/~media/archive/files/about-icaew/what-we-do/policy/public-finances/7378-web-icaew-cfo-at-cabinet-table-final.pdf> or is available on request.

### Currency and monetary policy

11. Projections in chapter 2 (*Scotland's Finances*) of the white paper show the need for an independent Scotland to borrow to fund expenditure. The UK Government has recently announced that it will underwrite all Government debt issued up to the date of Scottish independence, as the markets are already indicating that interest rates would begin to price in the risk of some of the debt obligations being taken on by an independent Scotland. This would indicate that, without a track record of debt funding, Scotland may find it more expensive than the rest of the UK (rUK) to raise new debt on the gilts market; there appears

to be no mention of this probability in the white paper. In our view, this possibility should be factored in to the expenditure projections.

12. If rUK was to agree to Scotland retaining sterling as its functional currency, the white paper envisages that the Bank of England would retain its role of managing monetary policy and maintaining financial stability for the sterling area. Scotland and rUK would share governance of the Bank of England but, inevitably, rUK would be the major stakeholder. Assuming that the white paper's vision of robust Scottish economic growth is realised, whilst the rUK is by implication less successful, the Bank of England would either have to implement policies that satisfied the needs of neither country or, more likely, favour the major stakeholder at the expense of Scotland. This may be an unsatisfactory outcome for all.
13. Scotland's annual Budget would have the potential to affect the market's view of sterling and thus the rUK economy (the Bank of England would retain its role as lender of last resort). If rUK was to pursue different economic policies (indeed, the case for independence is built around the opportunity for Scotland to differentiate policies), it may, as the major stakeholder, insist on the power to veto the Scottish Budget. As the 'junior partner', Scotland would be unlikely to be able to insist on the same power over the rUK Budget.
14. An independent Scotland aspires to EU membership. Advice received by the Scottish Government is that this would not require adoption of the Euro; the Westminster Government disagrees. There may therefore be the possibility that Scotland would have to join the Exchange Rate Mechanism and, for two years prior to joining the Euro area, maintain its existing currency (sterling) within interest and exchange rate band limits imposed by the EU. This would be an unlikely priority for the Bank of England in managing monetary policy for rUK, and equally unlikely that the Westminster Government would countenance running the rUK economy to suit the needs of Scotland.
15. Even if adoption of the Euro is not a requirement of EU membership, it is one of the options if the retention of sterling is not possible; the above comments apply equally. Given its troubled recent history, it is unlikely that the Scottish people would react positively to adopting the Euro. Retaining sterling as the functional currency would be extremely important for a new Scottish Government which would not be the best position from which to negotiate.
16. We are concerned that there may be no political will from the rest of the UK to establish the joint regulatory framework outlined on p113 of the white paper and upon which much of the subsequent financial structural arrangements depend.
17. With the establishment proposed of Scottish financial regulatory bodies, if separate regulations were to be applicable in future it is a risk that organisations, currently providing financial products across the UK, would choose to avoid subjecting themselves to such a duplication of regulation and only offer those products to the rest of the UK. This could have an adverse effect on the financial services industry in Scotland.
18. The description of the proposed regulatory environment focuses only on financial institutions and does not provide guidance for other companies and public interest bodies. There appears to be some uncertainty about the transfer of certain activities currently carried out by the UK Financial Reporting Council. For example, it currently regulates ICAS (Institute of Chartered Accountants of Scotland) and sets accounting standards used by many private companies. One area of uncertainty, for example, is whether private Scottish companies would, under independence, be able to continue to apply UK GAAP (generally accepted accounting principles) or would be required to change to apply the international accounting standards.

19. In the absence of political will for both retention of sterling and the common regulatory framework there would be a need to re-work the proposals in the white paper. We would like to see much more certainty and positivity, including from UK Government, now on these crucial questions.
20. In international funding markets mortgage lenders raise their rates when customers borrow for properties not in the lender's home market – for example borrowing in the UK to buy a villa in Spain. In the event of a “Yes” vote, lenders in the rest of the UK could seek to charge more for mortgages in the “foreign” market of Scotland. The pool of Scottish lenders could also become more limited (and in this situation become less competitive) which could lead to home owners and commercial operations with property assets paying more expensive repayments as lenders raise their rates.

## **Fiscal policy**

21. The white paper lacks detail in respect of the tax system, how taxes will be raised and expected yields. Indeed, according to the opening of the paragraph headed “Our priorities for action” in the Taxation section of Chapter 3, “Detailed policies on tax and spending will be set out in party manifestos for the 2016 election and thereafter in the first budget in an independent Scotland.” We feel that this timescale is a concern, given the importance of a suitable tax system within the economic case for independence, which must be set out now.
22. We support the call for a straightforward and simplified tax code in Scotland. However, the declared intention to construct a taxation system to stimulate the economy, build social cohesion and stimulate public services would, by its nature, require a certain level of complexity as it seeks to shape corporate and individual behaviour.
23. The white paper recognises current tax complexity, acknowledges that Westminster has the office of tax simplification, and states that reliefs and exemptions within the UK tax system are too complex. Designing a new tax code and consulting widely with business and trade unions is discussed. Naturally, different business organisations have their own agendas and interests. If a simple and effective tax code is required, it might be argued that that this should be done without involving vested interests from any particular business type, size or sector.
24. The impact of different tax rates raises issues of complexity as well as administration and collection costs. In previous submissions to consultations and inquiries, we have mentioned the taxpayers' actions to minimise tax and the danger of tax administrators creating a ‘race to the bottom’, especially with regard to corporation tax. In December 2011, ICAEW Scotland responded to Scottish Government Discussion Papers on Corporation Tax, in the context of devolving corporation tax in the Scotland Bill. We feel it is worth repeating some of the points from that response, which would apply to any alterations to Corporation Tax rates, whether implemented under an independent or devolved constitution. This extract is attached as Appendix I.
25. It is very difficult to quantify how many companies currently headquartered in UK would seek to be headquartered in Scotland to benefit from reduced Corporation Tax rates. It is equally hard to predict how many companies may relocate from outwith UK to take advantage of the corporate tax regime open to companies settling in Scotland through inward investment. As stated above the quantum of Corporation Tax currently paid by Scottish business is unknown, but there remains the hope that the relocating companies would generate sufficient additional CT income to counteract the reduced revenue from the existing Scottish businesses.

26. We note that the white paper suggests examining the case for an increase in National Insurance employment allowance for small businesses. While we accept this may be an incentive to employment as one of a package of incentives, we feel that the cost of the tax take and benefits for businesses may not stack up if this is a stand-alone initiative.
27. Page 121 of the White Paper states a target revenue gain of £250 million a year by the end of the first term, to be gained from reduced compliance costs, streamlined reliefs and reduced tax avoidance. We are concerned at the lack of detail provided on the breakdown of this figure and would like to see more details on this figure. There also appears here to be an assumption that the tax gap (the difference between tax collected and that which, in the view of HMRC or another tax collecting agency, should be collected) in an independent Scotland would be smaller than the UK's, but we believe that there is an equal risk that the Scottish tax gap could in fact be equal or greater to the UK's current level.
28. Page 122 of the White Paper includes four design principles for a modern and efficient tax system (set out by the Fiscal Commission). The ICAEW Tax Faculty has developed ten tenets for a better tax system. These are included as Appendix II. Based on these tenets, we highlight the need for a tax system to be subject to proper consultation; and certain but regularly revised, in addition to the four principles included in the White Paper.

### **Economic focus**

29. The Scottish government has demonstrated success in encouraging sectoral expertise such as in sustainable energy. Building on such achievements is an important element of successful economic growth in the future and should be pursued whatever the outcome on 18 September.
30. A greener future is attainable for Scotland, with or without full independence, and should be encouraged amongst the business community. The participation of ICAEW Scotland in the Prince's May Day pledge has seen a reduction in the carbon footprint of events and meetings.
31. Manufacturing should be supported and encouraged through specific measures – for example skills training and capital investment - but the provision of this has cost implications for the national budget.
32. Our quarterly survey of businesses across the UK, the ICAEW/Grant Thornton Business Confidence Monitor, (BCM) points to trends in how businesses are operating both across different sectors and in different parts of UK.
33. During 2013 there was a decline in the intentions of businesses in Scotland to invest in R&D and in capital equipment. This may protect their cash position in the short term, however it can be damaging for longer term progress and growth of these businesses.
34. Where firms have indicated that they have been willing to invest is in the retention of their labour force, by maintaining staff levels even where operations were below capacity. However, for the growth of the Scottish economy the pay rates need to regain some of the real values lost over the past 5 years. This will only be achieved when businesses are operating at closer to full capacity and the economic situation as a whole improves.

## Communications and IT Infrastructure

35. We note the intention of an independent Scotland to restore the portion of the recently privatised Royal Mail within Scotland to public ownership, to retain the universal postal services and to maintain stamp prices at independence. However there needs to be more information obtained and/or made available to the electorate as to whether this is a viable and sustainable ambition.
36. Perhaps a less pressing point, but worthy of inclusion, is that whilst we welcome the application for the dotSCOT top level domain, we note the comment that: “an independent Scotland would also be entitled to a new two-letter country code top-level domain...”. As all the obvious abbreviations for Scotland (dotSC, dotST, dotSD, dotES (Escosse), dotCA (Caledonia) and dotAL (Alba)), are already used by other nations (see Appendix III), it is unclear what domain, if any, would benefit Scottish businesses.

Extract from ICAEW Scotland's *Feedback on the Scottish Government's Discussion Paper on Corporation Tax: Options for Reform (August 2011)* and the subsequent paper, *Devolving Corporation Tax in the Scotland Bill (September 2011)*

### **Concerns over stability of a devolved Corporation Tax**

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. Devolved Corporation Tax in the wider context of the Scotland Bill proposals

Nevertheless, whilst a devolved corporation tax alone might perhaps be excessively volatile, it is important to place it in the wider context of a broad-based devolution of tax-raising powers and responsibilities. As part of a 'suite' of devolved taxes, any volatility in the corporation tax rate could be absorbed within the devolved government's wider fiscal policy.

It is also important to consider some of the potential consequences of not devolving corporation tax.

Under the current Scotland Bill proposals, part of the income tax arising on employment and self-employment income within Scotland will be devolved to the Scottish government.

There is, of course, a strong desire within Scotland to use this devolved power to encourage business growth within Scotland through a reduction in Scottish income tax rates. However, as we have commented previously in our responses to consultations on the Scotland Bill, the current proposals may have the adverse effect of providing greater benefit to the UK tax take flowing to Westminster whilst providing little or no benefit to the Scottish tax take flowing to Holyrood.

By not devolving corporation tax to the Scottish Government, there may be another unintended and perverse effect. If devolved income tax rates are used to generate growth in the Scottish economy, new and existing businesses will grow and prosper. As businesses grow, there generally comes a point when it becomes sensible to transfer the business into a company (known as 'incorporation'). Hence, the business will move from generating income tax to generating corporation tax.

If corporation tax is not devolved to Scotland, the unintended and perverse consequence of these business incorporations will be that the Scottish tax yield falls and the UK tax yield rises. This will further exacerbate the difficulties discussed above – once again, the Scottish government's efforts to stimulate economic growth in Scotland will result in additional tax revenues flowing to Westminster rather than the benefit of Scotland.



## **The ‘Irish Miracle’ and Scotland**

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.

### **Corporation Tax Rates**

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 23% 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 for a reduced corporation tax take in the short term.

A more fundamental problem is that a policy of pursuing corporation tax reduction can 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. It may therefore be sensible to examine additional tax incentives that can be focused on activities that will specifically support genuine investment and growth in Scotland rather than encourage the type of ‘artificial’ head office relocations seen in Ireland.

For many reasons, including those outlined above, Scotland is in a very different position to both the Republic of Ireland and to Northern Ireland. Hence, there is no ‘one size fits all’ solution to devolved corporation tax rates within the UK.

Northern Ireland has the specific problem of competing with its immediate neighbour to the South, especially in the critical area of attracting inward investment. Scotland's position is very different. As a well-established industrialised economy, Scotland can be seen as more of a 'mainstream' (although small) European nation. Scotland has a well-established economic infrastructure of its own and can therefore look more to internal investment and growth rather than relying excessively on inward investment.

This different picture in Scotland leads to a very different view on the sort of differential required in the corporation tax rates. Whereas Northern Ireland needs to look predominantly at inward investment and therefore requires a very substantially reduced rate of corporation tax, Scotland can look more at encouraging the growth of an existing economy – thus requiring only a more reasonable (but still significant) reduction in corporation tax rates.

With a smaller differential between the corporation tax rate in Scotland and elsewhere in the mainland UK, there would also be less risk of 'tax tourism', or arbitrage, undermining the UK economy.

### **The effect of additional complexity**

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 corporation tax rates within the UK will increase the complexities of an already complex area. It is therefore important to ensure that the benefits of a reduced rate outweigh the increased complexity and costs that arise.

In our tax representation 'Rebalancing the Northern Ireland Economy', we pointed out that business representatives generally believe that the attribution of profits to branches and other permanent establishments can be managed relatively easily but that problems are likely to arise when it becomes necessary to consider what overheads and other costs such as interest should also be set against profits arising in the devolved territory.

While multinational companies operating outside the UK will already have mechanisms in place for the allocation of profit to extend this to the UK may involve a substantial amount of work. Companies whose current operations are confined to the UK may have to incur substantial costs in installing new systems to provide the necessary accounting information.

We note that this paper suggested that the costs to business of introducing a separate rate of corporation tax in Northern Ireland might be as much as £50m and the cost in Scotland would be expected to exceed that in Northern Ireland.

There is a danger that the additional costs of tax compliance may act as a disincentive to companies setting up business in Scotland, regardless of the rate of tax. We point out that companies will have to incur these costs even if they do not have taxable profits and so do not benefit from any reduction in tax. Also there may be companies that make losses in Scotland and profits in England or vice versa who may be unable to offset these losses and so will pay more tax than at present. It would be much better if tax incentives could be offered in a different form (such as enhanced capital allowances) so that only those companies that were able to benefit would suffer additional costs.

## APPENDIX II

### ICAEW TAX FACULTY

#### THE TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

## APPENDIX III

### COUNTRY CODE TOP-LEVEL DOMAINS

A .ac .ad .ae .af .ag .ai .al .am .ao .aq .ar .as .at .au .aw .ax .az

B .ba .bb .bd .be .bf .bg .bh .bi .bj .bm .bn .bo .br .bs .bt .bw .by .bz

C .ca .cc .cd .cf .cg .ch .ci .ck .cl .cm .cn .co .cr .cu .cv .cw .cx .cy .cz

D .de .dj .dk .dm .do .dz

E .ec .ee .eg .er .es .et .eu

F .fi .fj .fk .fm .fo .fr

G .ga .gd .ge .gf .gg .gh .gi .gl .gm .gn .gp .gq .gr .gs .gt .gu .gw .gy

H .hk .hm .hn .hr .ht .hu

I .id .ie .il .im .in .io .iq .ir .is .it

J .je .jm .jo .jp

K .ke .kg .kh .ki .km .kn .kp .kr .kw .ky .kz

L .la .lb .lc .li .lk .lr .ls .lt .lu .lv .ly

M .ma .mc .md .me .mg .mh .mk .ml .mm .mn .mo .mp .mq .mr .ms .mt .mu .mv .mw .mx .my .mz

N .na .nc .ne .nf .ng .ni .nl .no .np .nr .nu .nz

O .om

P .pa .pe .pf .pg .ph .pk .pl .pm .pn .pr .ps .pt .pw .py

Q .qa

R .re .ro .rs .ru .rw

S .sa .sb .sc .sd .se .sg .sh .si .sk .sl .sm .sn .so .sr .ss .st .su .sv .sx .sy .sz

T .tc .td .tf .tg .th .tj .tk .tl .tm .tn .to .tr .tt .tv .tw .tz

U .ua .ug .uk .us .uy .uz

V .va .vc .ve .vg .vi .vn .vu

W .wf .ws

Y .ye .yt

Z .za .zm .zw