A widening divide

Management of taxes

01 June 2017

Joanne Walker and *Chris Young* look at the state of play in relation to devolution of tax in Scotland

Key Points

What is the issue?

The devolution of taxation powers to the Scottish Parliament has now been ongoing for several years. However, many taxpayers in Scotland will as yet have been unaware of this. With the partial devolution of Scottish income tax powers taking effect from 6 April 2017, and the divergence in the higher rate threshold, the visibility of tax devolution has increased significantly.

What does it mean to me?

Given the increased visibility of tax devolution in Scotland, now is a good time to take stock of the current state of play. This includes being aware of not only which taxes have been/will be devolved, but understanding the position in relation to income tax and VAT. In addition, there have been complementary changes in relation to tribunals and the establishment of Revenue Scotland and the Scottish Fiscal Commission.

What can I take away?

The position as at April 2017 in relation to the devolution of taxation powers to Scotland is summarised as follows: taxes on property transactions and landfill disposals have been fully devolved; income tax remains a ‘shared tax’, with the devolution of powers to set rates and bands for non-savings, non-dividend income. Looking to the future, air departure tax will replace air passenger duty in Scotland from April 2018 and a share of VAT revenues will be passed to the Scottish government from April 2019.

Scotland

The devolution of taxation powers to the Scottish Parliament has been an ongoing process, one that can be traced back to the foundations of the devolution settlement 20 years ago. Since its establishment in 1999, the Scottish Parliament has had the power to raise a proportion of the money that it spends through tax raising powers.

The very question of whether the Parliament should have that power was one that was put to the public in the devolution referendum of 1997, with overwhelming support.

Alongside existing forms of local taxation (council tax and business rates), the Scottish variable rate introduced an element of fiscal responsibility to the country’s devolution settlement.

However, this power was never used. Nevertheless, as Scotland’s devolution journey has evolved, so too has the range and scope of tax raising powers evolved with it.

From almost total reliance on block grant funding from Westminster in 1999, the latest round of new tax raising powers means that by 2019/20, the Holyrood Parliament will be responsible for raising around half of the money that is spent north of the border.

It is perhaps debatable whether many Scots were ever aware of the Parliament’s tax raising powers. But with the Scottish Parliament’s power to set income tax rates and bands for non-savings and non-dividend income of Scottish taxpayers from this April, Scotland’s tax raising powers are suddenly much more visible to taxpayers. It therefore feels like an opportune moment to take stock of how Scotland’s tax devolution journey has evolved.

Local taxes

Responsibility for raising revenues through local taxes long preceded devolution. Both council tax and non-domestic rates (business rates) are administered by local authorities. Council tax is governed by the Local Government Finance Act 1992, with responsibility for the overall policy and legislative framework a matter for the Scottish government and Parliament. Each of Scotland’s 32 councils are responsible for setting the rate in their local area. Non-domestic rates date back centuries in Scotland, but were modernised in the nineteenth century with further amendments being made by the Local Government Finance Act 1988.

The issue of local government finance has long been a contentious issue and in the post-devolution years, attempts have been made by successive Scottish administrations to initiate reform. In 2006, the Local Government Finance Review Committee (Burt Review) set out detailed proposals for reform which were never implemented, while during the 2007/2011 parliament, attempts to introduce a local income tax were unsuccessful. In recent years, the Scottish government has established independent commissions to consider both council tax (the Commission on Local Tax Reform) and non-domestic rates (the Barclay Review Group). The findings of the former led to a change in the ratios used to calculate tax liabilities on properties in bands E-H of the council tax scales, which took effect in April of this year. The review of non-domestic rates is currently ongoing, with the Barclay group due to report to Scottish government ministers this summer with proposals for reform.

Scotland Act 1998

The evolution of Scotland's tax raising powers can be traced back to the UK General Election of 1997, which saw the coming to power of a Labour government elected on a pledge to hold a referendum on Scottish devolution. That September, Scottish voters backed the concept of a Parliament with tax raising powers by a margin of 63% to 37%. Part IV of the subsequent Scotland Act 1998, which created the Scottish Parliament, provided for the introduction of a 'tax-varying power' – the Scottish variable rate – which allowed Parliament to increase or decrease the basic rate of income tax by up to 3%. In the event, the Scottish Parliament never exercised this power, which would have involved significant implementation costs in order to raise relatively little revenue.

Scotland Act 2012

Further tax devolution came with the Scotland Act 2012. The Act was the ultimate result of the Commission on Scottish Devolution (better known as the Calman Commission), which was established with the support of the Scottish Parliament's opposition parties to review the Scotland Act 1998 and to recommend changes to the devolution settlement. It published its final report in mid-2009 and recommended that a range of tax raising powers be devolved to the Scottish Parliament. These included: the power to set a Scottish rate of income tax and the devolution of air passenger duty, landfill tax, stamp duty land tax and aggregates levy.

Following its election at the 2010 UK General Election, the Conservative and Liberal Democrat coalition government pledged to implement the Commission's recommendations and the Scotland Act 2012 took them forward. Part 3 of the act provided for a Scottish rate of income tax, which was to take effect during the 2016/17 tax year. This applied only to the non-savings and non-dividend income of Scottish taxpayers, and gave the Scottish Parliament the power to set one rate, which was added to each of the UK rates of tax (basic, higher and additional) minus 10%. As the decision taken was to set a Scottish rate of 10%, the effect was to cancel out the 10% reduction, meaning the rates of tax paid by Scottish taxpayers in 2016/17 were exactly the same as those paid by UK taxpayers.

The Calman recommendations in relation to air passenger duty and aggregates levy were not adopted by the UK government at this time. The Scotland Act 2012 (Part 3) did however provide for the full devolution of taxes on transactions involving interests in land and on disposals to landfill. This led to the replacement of stamp duty land tax by land and buildings transaction tax on transactions relating to land in Scotland, and the replacement of landfill tax by Scottish landfill tax on disposals to landfill made in Scotland with effect from 1 April 2015. While Scottish landfill tax closely mirrored the UK equivalent, the Scottish government moved away from the 'slab tax' structure that stamp duty land tax had at the time, prompting a similar move by the UK government.

The Scotland Act 2012 specifically set out that the collection and management of a devolved tax is a function of the Scottish Ministers, paving the way for the Revenue Scotland and Tax Powers Act 2014, which established Revenue Scotland and gave it the general function of the 'collection and management' of wholly-devolved taxes, as defined by the Scotland Act 1998. It also set up an overarching framework for the devolved taxes, including record-keeping requirements and provisions in respect of tax returns, enquiries and penalties. The Revenue Scotland and Tax Powers Act 2014 also provided for reviews and appeals and established the Scottish Tax Tribunals, which have recently been folded into the Scottish Tribunals, for dealing with appeals in relation to devolved taxes.

Scotland Act 2016

Immediately following the declaration of the result of the Scottish independence referendum of September 2014, the then UK Prime Minister announced plans for a further review of Scotland's devolution settlement. The Smith Commission was tasked with taking forward a pledge made in the final days of the referendum campaign by the UK leaders of the Conservatives, Liberal Democrats and Labour that further powers would be devolved to Scotland in the event of voters choosing to remain part of the United Kingdom.

The final report and recommendations of the cross-party Commission were published in November 2014. They formed the basis for the Scotland Act 2016, which the UK government introduced.

Part 2 of the act gave the Scottish Parliament the power to set rates and bands of income tax. As with the Scottish rate of income tax, these powers extend only to the non-savings and non-dividend income of Scottish taxpayers. In addition, although Scotland keeps these income tax receipts, HM Revenue & Customs continue to collect and administer all income tax throughout the UK. This is because income tax remains a shared tax, and the UK Parliament retains full control of the tax base, including allowances, deductions and reliefs. These income tax powers took effect from 6 April 2017, so although the initial intention had been that the Scottish rate of income tax would remain in place for a few years, changing events meant it lasted for only one tax year (2016/17) before being superseded.

Whereas the Scottish government maintained parity with the rest of the UK when exercising the power to set a Scottish rate of income tax for 2016/17, there has already been divergence from the rest of the UK in respect of the power to set rates and bands of income tax. The initial proposal was to increase the higher rate threshold for the non-savings and non-dividend income of Scottish taxpayers by inflation only for 2017/18; as a result of budget discussions however, the final decision was to freeze the higher rate threshold at the 2016/17 level of £43,000. In contrast, the higher rate threshold for taxpayers in the rest of the UK has increased by £2,000 to £45,000 for 2017/18.

Part 2 of the act also provides for the assignment of VAT revenues – the first 10 percentage points of the standard rate and the first 2.5 percentage points of the reduced rate of VAT attributable to Scotland. The method of identifying the VAT attributable to Scotland is subject to agreement between the UK Treasury and Scottish Ministers. This is currently under discussion, with VAT assignment expected to take effect from 1 April 2019.

Neither of the above two provisions result in full devolution of the taxes in question, meaning neither income tax nor VAT are defined as devolved taxes. As a result, they do not fall within the framework established by the Revenue Scotland and Tax Powers Act 2014, but are administered by HM Revenue & Customs, with appeals dealt with by the UK Tribunals system.

The act provides for some full tax devolution, however, in respect of the carriage of passengers by air and the commercial exploitation of aggregate. The Scottish government has already consulted on the former and air departure tax is expected to replace air passenger duty in respect of the carriage of passengers by air from airports in Scotland with effect from 1 April 2018. The Scottish government is yet to decide on a date for replacing aggregates levy with an equivalent Scottish devolved tax.

Fiscal framework

As well as making recommendations in respect of the further devolution of tax powers, the Smith Commission concluded that there needed to be an updated fiscal framework for Scotland, consistent with the overall UK fiscal framework. This was not included in the Scotland Act 2016. Instead, the Scottish and UK governments agreed a new fiscal framework in February 2016. This is consistent with the principles in the Smith Agreement, including the continued use of the Barnett Formula to determine changes in the Scottish government's block grant. In addition to setting out how the block grant will be adjusted in respect of devolved taxes when they are first devolved (the baseline adjustment), the framework also sets out the indexation mechanism that will be used to adjust the block grant in future years.

Scottish Fiscal Commission

A final piece of the picture is the Scottish Fiscal Commission, which was set up as a non-statutory body following the Scotland Act 2012. From June 2014 to March 2017 it had responsibility for independently scrutinising and assessing Scottish government forecasts of devolved tax receipts. In response to the increased devolution of both taxation and social security powers, the Scottish Fiscal Commission has been placed on a statutory footing (the Scottish Fiscal Commission Act 2016), with its Commissioners being accountable to the Scottish Parliament. In April 2017 the Commission became responsible for producing independent forecasts for Scotland, including of tax revenues and expenditure on social security.

Northern Ireland and Wales

Devolution is not restricted to Scotland, although that has been the focus of this article. Following a referendum in September 1997, the Government of Wales Act 1998 established the National Assembly for Wales. The Northern Ireland Act 1998 established the Northern Ireland Assembly following a referendum in May 1998.

In response to the work of the Silk Commission, the Wales Act 2014 and Wales Act 2017 provide for the devolution of taxes to the Welsh Assembly. A devolved Welsh land transaction tax and a devolved Welsh landfill tax are expected to take effect from April 2018. The Welsh Revenue Authority will administer these devolved taxes. Partial control of income tax on non-savings and non-dividend income of Welsh taxpayers will be devolved from April 2019.

The power to set air passenger duty rates on direct long-haul flights departing from airports in Northern Ireland was devolved to the Northern Ireland Assembly by the Finance Act 2012. The Assembly has set these rates at nil with effect from 1 January 2013. The Corporation Tax (Northern Ireland) Act 2015 provides for the devolution to the Northern Ireland Assembly of power to set a rate of corporation tax. Although the Northern Ireland Executive has committed to setting a rate of 12.5% to take effect from April 2018, the power will only be devolved once the Executive has demonstrated its finances are on a sustainable footing.

Both the Welsh Assembly and the Northern Ireland Assembly can pass laws in respect of local taxation, like the Scottish Parliament.

Conclusion

Devolution of tax powers to the Scottish Parliament has been evolving over the past 20 years, but the past five years have seen a significant increase in tax devolution. This means increased accountability as a greater proportion of the Scottish government’s budget comes from fiscal decisions taken by the Scottish Parliament. It is perhaps the partial devolution of income tax powers that may do the most to increase the visibility of tax devolution among the Scottish public.