Implementing the Scotland Act 2012

An update

AUDITOR GENERAL

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Auditor General for Scotland

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2 The Scottish Government and HMRC are working well together in preparing for the introduction of the Scottish rate of income tax in April 2016. The estimated cost range of setting up the Scottish rate of income tax has decreased by £10 million, to between £30 million and £35 million.

3 The Scottish Government established its Fiscal Capability 2015 Programme to oversee the introduction of the new financial powers in the Scotland Act 2012. It has made good progress in modifying its existing arrangements to accommodate the new powers. Some arrangements to manage the powers beyond 2015/16 are still being developed. The Scottish and UK Governments have yet to agree the terms of the block grant adjustment for the devolved taxes after 2015/16. The Scottish Government is developing longer-term arrangements for capital borrowing and accounting arrangements for the devolved taxes and capital borrowing. This is a reasonable approach, given that the fiscal framework is yet to be agreed with the UK Government. These are important elements of sound financial management that will need to be fully developed quickly following agreement of the framework.

Recommendations

To help improve the management and reporting of its new financial powers, the Scottish Government should:

- progress its strategy for capital borrowing, following an agreement on the updated fiscal framework, setting out details of decision-making processes and procedures for borrowing (paragraph 71)

- progress financial reporting arrangements for devolved tax receipts and capital borrowing liabilities as a priority, ensuring that reporting is consistent, transparent and in line with public sector financial accounting frameworks (paragraph 73).

Background

1. The Scottish Parliament is seeing its financial powers increase substantially, with changes as a result of the Scotland Act 2012 and proposals for further devolution in the Scotland Bill 2015 (Exhibit 1, page 6). These changes have significant implications for Scotland's public finances and how they are managed and reported.

2. Taken together, the powers in the Scotland Act 2012 and the proposals in the Scotland Bill 2015 have significant implications for the Scottish budget and the Scottish Parliament's spending responsibilities. Revenues raised in Scotland would increase by around £17 billion to about £21 billion and spending would increase from £37.5 billion to about £40 billion.[1]

3. It is important that effective arrangements are in place to manage these new powers and that financial reporting is comprehensive, transparent, reliable and timely.[2]

4. The position is changing quickly. The Scottish Government is implementing the powers in the Scotland Act 2012 at a time when work is ongoing to agree further financial powers. In particular, its development of financial management and reporting arrangements is happening within the context of work to update the fiscal framework to accompany the further powers proposed in the Scotland Bill 2015.[3]

About this report

5. This report focuses on the implementation of the financial powers in the Scotland Act 2012. In December 2014, we published a report that assessed the Scottish Government's progress up to November 2014.[4] Since then, preparations have continued and some of the new powers are now in force. This report provides an update on progress.

6. The report is in three parts:

- Part 1 assesses how effectively Revenue Scotland implemented and is collecting the two devolved taxes introduced in April 2015.
- Part 2 examines how the Scottish Government is working with HM Revenue and Customs to prepare to introduce the Scottish rate of income tax in April 2016.
- Part 3 looks at how the Scottish Government is developing its financial management and reporting under the current arrangements set out in the Scotland Act 2012.

Exhibit 1

The introduction of new financial powers in Scotland

New financial powers were included in the Scotland Act 2012 and are proposed in the Scotland Bill 2015.

	Scotland Act 2012	Scotland Bill 2015 (proposed powers)[1]
Devolved taxes	Two taxes devolved from April 2015 that are collected by Revenue Scotland:[2] • Land and Buildings Transaction Tax (estimated revenues of £381 million) • Scottish Landfill Tax (estimated revenues of £117 million)	Devolution of two further taxes: • Air Passenger Duty (estimated revenues of £251 million) • Aggregates Levy (estimated revenues of £50 million)
Income tax	The Scottish Parliament will set a Scottish rate of income tax for Scottish taxpayers each year from April 2016 (estimated revenues of £4.9 billion)[3]	The power to set income tax rates and bands on earned income and to retain the tax collected from Scottish taxpayers (estimated revenues of £10.9 billion)
Value Added Tax (VAT)	N/A	Assigning a share of the VAT collected in Scotland to the Scottish Government's budget (estimated revenues of £5 billion)
Borrowing	From April 2015: • Up to £500 million revenue borrowing from the National Loans Fund • Operation of a cash reserve up to £125 million • Borrowing up to a total limit of £2.2 billion for capital spending	Additional revenue and capital borrowing powers may be agreed
Social security	N/A	Responsibility for social security powers worth an estimated £2.5 billion

Notes: 1. Estimated annual revenues from the powers in the Scotland Bill 2015 are from *Government expenditure and revenue Scotland 2013/14*, Scottish Government, March 2015. 2. Estimated devolved tax revenues for 2015/16 are from Scottish Government forecasts. 3. Forecast revenues from the Scottish rate of income tax in 2016/17 are from *Economic and fiscal outlook: devolved taxes forecast*, Office for Budget Responsibility, November 2015. This estimate assumes that the Scottish rate of income tax will be ten pence.

Source: Audit Scotland

7. Our findings are based on reviewing documents and talking to representatives from organisations involved in implementing the new financial arrangements. The audit methodology for this report is in the Appendix.

8. We will continue to monitor the Scottish Government's progress in implementing new financial powers and in developing its financial management and reporting arrangements, and will publish our findings.

Part 1

Devolved taxes

Key messages

1 Revenue Scotland successfully implemented the two devolved taxes on time. The IT system and people needed to collect and manage the taxes were in place by the time the taxes were introduced.

2 It cost £5.5 million to implement the devolved taxes, £1.2 million more than originally estimated. This was due mainly to the need for additional staff in the set-up phase.

3 Revenue Scotland has established arrangements for making sure taxpayers pay the right amount of tax, but it is too early to assess their effectiveness. It is refining its systems and processes, taking account of its experience in administering the taxes.

4 Revenue Scotland has identified lessons learned from implementing the two devolved taxes, and is applying these in preparation for further devolved taxes.

Revenue Scotland successfully implemented the two devolved taxes on time

Revenue Scotland started collecting the two devolved taxes from the date they were introduced

9. Revenue Scotland was established on 1 January 2015 and is responsible for collecting and managing devolved taxes in Scotland. It began collecting the Land and Buildings Transaction Tax (LBTT) and the Scottish Landfill Tax (SLfT) from the dates from which payments could be made, that is 1 April 2015 and 1 July 2015 respectively. Revenue Scotland received tax returns for transactions totalling £218 million in LBTT in the first seven months of 2015/16, and £37.4 million in SLfT in the first three months.

Effective project management helped deliver the programme on time

10. The Scottish Government established effective structures for managing the implementation of the devolved taxes, through its Tax Administration Programme (TAP). It produced detailed project plans and appointed a programme director in summer 2014. These were important in helping Revenue Scotland implement the devolved taxes in the time available.

11. Revenue Scotland put effective arrangements in place to identify, respond to, and manage issues as they arose. In July 2014, the Scottish and UK Governments agreed criteria and indicators to assess Revenue Scotland's readiness to collect and manage the devolved taxes. Revenue Scotland aligned all projects within the TAP against these criteria and used a traffic light system of red, amber and green to indicate the level of risk to planned delivery. Items assessed as amber or red were escalated to the necessary level to ensure action was taken to bring them back on track.[5] Regular monitoring and reporting against the readiness criteria and TAP risk register ensured that the programme team and TAP board, and the Revenue Scotland board from January 2015, were aware of progress and could quickly take action to address any potential problems.

12. Revenue Scotland worked closely with the Scottish Government, Registers of Scotland (RoS), the Scottish Environment Protection Agency (SEPA) and HM Revenue and Customs (HMRC) to prepare to introduce the taxes. Revenue Scotland agreed memorandums of understanding (MOUs) with RoS, SEPA and HMRC in March and April 2015. These set out clearly their roles, responsibilities and working arrangements. The MOUs are reviewed regularly, as it becomes clearer how their respective roles are working in practice.

The IT system and staff needed to collect and administer the devolved taxes were in place by the time the taxes came into effect

13. In December 2014, we reported that delays in procuring an IT system and putting staff in place had reduced the time available to develop the IT system and to appoint staff to Revenue Scotland.[6] At that point, we highlighted an increased risk that the IT system may not be fully operational by 1 April 2015 and Revenue Scotland may not have the expertise to manage the devolved taxes effectively from that date. This section of the report examines how Revenue Scotland managed these risks to ensure the IT system and staff it needed were in place by the time the taxes came into effect.

Revenue Scotland prioritised the development of its IT system to ensure it could collect and administer the two taxes on time

14. The IT supplier contracted to implement the system to collect and administer the devolved taxes started work in September 2014, and agreed an implementation plan with Revenue Scotland. It delivered the Scottish Electronic Tax System (SETS) in January 2015, in line with this plan. The implementation of SETS was split into three stages, to go live between February and June 2015:

- **Release 1A** – user registration and sign-up
- **Release 1B** – tax collection (LBTT and SLfT)
- **Release 1C** – additional functionality for Revenue Scotland staff.

15. Three releases of SETS went live in February, March and May, ensuring that taxpayers could submit their LBTT and SLfT tax returns online from 1 April and 1 July respectively (Exhibit 2, page 10). Revenue Scotland's effective project management arrangements helped it to prioritise the development of different parts of SETS, to ensure the elements required to collect and administer tax payments online were in place in time. For example, Revenue Scotland moved some functions of SETS from release 1B in March to release 1C in May. This included the development of the online form for SLfT returns, which was not needed until SLfT started to be collected from 1 July 2015, and the pre-population of user details for LBTT. This allowed the IT supplier to focus on ensuring the elements necessary for the collection of LBTT were operational by 1 April 2015. The online forms for submitting tax returns for LBTT and SLfT were available before collection of the two taxes began, allowing users to familiarise themselves with the system.

Exhibit 2
Delivery of the Scottish Electronic Tax System
The IT system to collect and administer the devolved taxes was delivered in three stages.

16 Feb 2015 — **Release 1A** – users (principally solicitors and landfill operators) can set up accounts on SETS, allowing them to submit tax returns online from 1 April (LBTT) and 1 July (SLfT)

24 Mar 2015 — **Release 1B** – final online form for submitting LBTT returns made available to users. Systems in place to collect and administer LBTT

1 April 2015 — Collection of Land and Buildings Transaction Tax begins

26 May 2015 — **Release 1C** – final online form for submitting SLfT returns made available to users. Systems in place to collect and administer SLfT. Development of the case management system and introduction of extra features to make SETS more user-friendly

1 July 2015 — Collection of Scottish Landfill Tax begins

Source: Audit Scotland

16. Internal user testing of SETS began in December 2014, and detailed security and external user testing of SETS started in January 2015. Revenue Scotland received feedback from solicitors and landfill operators, both directly and through representative bodies such as the Law Society of Scotland. User feedback on the design and functionality of SETS as it was being developed helped ensure that it met taxpayers' needs before it was launched.

17. In the first month of operation, 98 per cent of LBTT tax returns were submitted online, and this has remained steady.[7] This is higher than Revenue Scotland's target of 90 per cent.[8] To make the system more user-friendly, Revenue Scotland introduced additional features to SETS following the launch of the two devolved taxes. For example, it started piloting direct debit payments for LBTT with solicitors in April and began to roll this feature out on a phased basis from August 2015. This is a new feature, which was not previously offered by HMRC.

Most of Revenue Scotland's operational team were in post by 1 April 2015
18. Revenue Scotland planned to recruit staff to its operational team in two phases. Twenty staff were to be in post by the end of January 2015 and a further 20 in post by the end of February 2015.[9]

19. Revenue Scotland prioritised recruitment to senior and specialist posts. It advertised across the Scottish Government and other government bodies to help attract candidates with the skills it required, such as tax specialists. By the end of January 2015, 22 operational staff were in post. By the end of February 2015, 31 people had accepted an offer of employment and 24 staff were in post.

20. In an update to the Scottish Parliament at the end of February 2015, Revenue Scotland noted that all of the essential posts in the senior management team and specialist areas were filled. These included tax, legal, finance, IT and corporate services. It also reported it had in place people with the expertise and experience required to collect and manage the devolved taxes.[10] By 1 April 2015, 37 people had accepted a post in Revenue Scotland's operational team and 31 of them were in post. By July 2015, all 40 operational staff were in place.

21. Nine staff from the programme team that set up the arrangements for collecting the devolved taxes moved to the operational team permanently. This benefited Revenue Scotland as their skills and knowledge were transferred into the operational team, ensuring continuity in important business areas.

It cost £5.5 million to implement the devolved taxes, £1.2 million more than originally estimated

22. The financial memorandum to the Revenue Scotland and Tax Powers Bill (RSTPB) was published in December 2013.[11] It estimated it would cost £3.2 million to set up the devolved taxes in Revenue Scotland, RoS and SEPA and an additional £1 million for developing IT in Revenue Scotland.

23. It cost around £5.5 million to establish the devolved taxes, over £1.2 million more than estimated in the RSTPB (Exhibit 3). This increase is largely due to staff costs in Revenue Scotland, which were £1.4 million more than estimated. Revenue Scotland identified the need for extra staff to lead and implement the TAP during 2014, to provide the skills and support needed to deliver the programme within the time available.

Exhibit 3

Final cost of establishing arrangements for collecting the devolved taxes

It cost £1.2 million more than estimated to set up Revenue Scotland and the two devolved taxes owing largely to staff costs.

Cost (£000s)	Estimate in RSTPB	Final total cost	Variance
Revenue Scotland staff	1,810	3,172	+1,362
Revenue Scotland non-staff	455	708	+253
Revenue Scotland IT development	1,000	854	-146
Registers of Scotland	335	325	-10
Scottish Environment Protection Agency	625	408	-217
	4,225	**5,467**	**+1,242**

Note: Final total costs are to 31 July 2015.

Source: *Revenue Scotland and Tax Powers Bill: financial memorandum*, Scottish Government, December 2013; and Revenue Scotland

24. In comparing the estimates in the RSTPB with actual costs, it is important to note that the arrangements that have been established differ from those on which the cost estimates were based. For example, decisions about the size of Revenue Scotland's operational team and the specification of the IT system to collect and administer the devolved taxes were made after the financial memorandum was published. As these decisions were made, Revenue Scotland revised the cost estimates and reported actual and forecast spending to the TAP board regularly. In November 2014, Revenue Scotland provided the Scottish Parliament with revised forecasts for implementing and running the devolved taxes. At this stage, it estimated that set-up costs would be £6 million.

Revenue Scotland's operating budget will need to reflect additional costs and responsibilities

25. Revenue Scotland's operating budget for 2015/16 is around £4.3 million. Most of this is for operational staff costs (£1.8 million) and goods and services (£1.7 million). The remaining £0.9 million is for staff costs to complete the implementation of the TAP (these figures are subject to rounding). Since agreeing its budget Revenue Scotland has identified additional costs for 2015/16, including further IT development and SEPA's costs in handling intelligence on SLfT on behalf of Revenue Scotland. Revenue Scotland is planning for the prospect of further devolved taxes following the implementation of the Scotland Bill 2015. The Bill includes measures for devolving two further taxes to Scotland: Air Passenger Duty and an Aggregates Levy. Revenue Scotland is using an underspend on the £0.9 million for staff costs in 2015/16 for implementing the TAP to support this work. The Scottish Government will need to reflect any additional costs in Revenue Scotland in its financial planning and budgets.

HMRC has charged the Scottish Government £0.73 million for it to stop collecting Stamp Duty Land Tax

26. HMRC charges the Scottish Government for costs associated with the devolution of Stamp Duty Land Tax, the UK tax that LBTT replaced. It estimates this will cost £1 million, most of which is for changes to its IT systems. For the period up to the end of 2014/15, HMRC has invoiced the Scottish Government for £0.73 million. HMRC will not pass any costs associated with the devolution of Landfill Tax on to the Scottish Government, owing to the small numbers of operators affected by the changes. From 2015/16, the UK Government will transfer any costs saved by HMRC from not operating Stamp Duty Land Tax or the Landfill Tax in Scotland to the Scottish Government. HMRC's cost savings of £0.3 million were transferred to Revenue Scotland's budget in the autumn budget revision for 2015/16.[12]

Revenue Scotland is using its compliance arrangements to recover unpaid tax

27. LBTT and SLfT are self-assessed taxes, which means that it is the individual taxpayer's responsibility to pay the correct amount of tax. As a result, tax that is due may not always be paid in full or at the right time, either accidentally or deliberately. Revenue Scotland aims to ensure that people comply with requirements to pay LBTT and SLfT. Its approach is based on good communication with taxpayers and by making it as easy as possible for people to pay what they owe. Examples of this include giving guidance to taxpayers on its website and by telephone, providing a straightforward system for submitting tax returns online, and responding to queries about specific transactions.

28. In the first half of 2015/16, 92.5 per cent of tax payments were made on time.[13] It is not possible to compare this to previous arrangements as HMRC does not publish equivalent information for Stamp Duty Land Tax or Landfill Tax. If someone submits a tax return but does not pay on time, Revenue Scotland contacts them or their solicitor to request payment. It starts formal proceedings to recover tax payments where necessary.

29. Revenue Scotland publishes data on the amount of tax owed and received each month. This shows that most late payments are recovered quickly. As at August 2015, Revenue Scotland had collected all SLfT owed for the first quarter of April to June 2015. As at November 2015, provisional figures showed that £0.2 million of LBTT was still owed for transactions in October 2015 totalling £34.8 million.

30. Revenue Scotland uses a range of methods to detect and deal with non-compliance, that is cases where people do not pay the correct amount of tax they owe (Exhibit 4). Where Revenue Scotland suspects non-compliance, it can use powers available through the Revenue Scotland and Tax Powers Act 2014 (RSTPA) to investigate and issue penalties. The General Anti-Avoidance Rule, which was established through the RSTPA, allows Revenue Scotland to take action against artificial tax avoidance schemes relating to the two devolved taxes.

Exhibit 4
Revenue Scotland compliance arrangements
Revenue Scotland's approach to compliance has three main stages.

Detection

- Validating and verifying information received in tax returns
- Sharing intelligence and information with other agencies
- Whistleblowing and other third party information
- Targeted activity with taxpayers who pose a high risk of non-compliance

Investigation

- Requesting further information from taxpayers and others to verify tax returns
- Inspection powers (for example, inspecting business premises, assets and documents)
- Inviting amended tax returns, where apparent errors are identified
- Issuing notifications of tax due, where a tax return has not been submitted

Enforcement

- Civil penalties (for example, a fine)
- Court action (for example, civil court action or criminal prosecution)

Source: Audit Scotland

31. SEPA carries out compliance activity for SLfT on behalf of Revenue Scotland. It worked closely with Revenue Scotland to set up compliance arrangements for SLfT. SEPA's experience of regulating landfill sites and knowledge of landfill operators meant that it could start highlighting potential non-compliance to Revenue Scotland as soon as SLfT returns started coming in. RoS supports Revenue Scotland's compliance activity for LBTT. Revenue Scotland provides information to RoS to allow it to check that tax returns have been submitted before it accepts land registration applications.

32. In the first six months of 2015/16, Revenue Scotland received tax returns for transactions totalling £220 million. Over the same period, Revenue Scotland recovered around £0.1 million of unpaid tax through its compliance activity. This included requesting further information from taxpayers and inviting them to amend their tax returns where errors were identified. As at 30 September 2015, Revenue Scotland had not issued any penalties or used its powers relating to the General Anti-Avoidance Rule.

33. While it is too early to assess fully the effectiveness of its compliance activities, Revenue Scotland is monitoring the amount of additional tax recovered. This will help to identify how effective its activities are. It will report annually against two indicators that measure the following:

- Value of tax liabilities identified. This is the value of additional charges made to taxpayers as a result of compliance activity.
- Direct compliance yield. This is the total amount of money Revenue Scotland receives as a direct result of its compliance activity.

34. Estimates of the tax gap, that is the difference between the tax collected and that estimated to be due, would help to indicate the scale and nature of non-compliance. Over time, it would also provide a long-term trend in Revenue Scotland's performance in tackling this. HMRC reports on the tax gap for the taxes it collects, but recognises that it is inherently difficult to estimate and carries a degree of uncertainty.[14] Several years of Scotland-specific data on the devolved taxes will be needed to make reasonable estimates of unpaid tax.

Revenue Scotland is refining its systems and processes

35. Revenue Scotland worked closely with stakeholders, such as solicitors and landfill operators, in developing the arrangements for the devolved taxes. It consulted in a range of ways as it was setting up the two taxes including through the Devolved Tax Collaborative. This is a group set up by the Revenue Scotland programme team to consult with external stakeholders on the devolved taxes.

36. Revenue Scotland is building on this to refine and improve the systems and processes that support its tax collection role. For example, it uses feedback from callers to its support desk and comments left on its website to update and improve its guidance. It has established separate forums under the Devolved Tax Collaborative, for LBTT and SLfT, to discuss practical and technical issues. Examples include any problems taxpayers have when submitting tax returns or aspects of the guidance that need to be clarified. Revenue Scotland also continues to seek feedback from the professional tax bodies that were involved in testing SETS (paragraph 16). Revenue Scotland plans to provide information in its 2015/16 annual report, which will be published in 2016, about how it has used feedback to improve its service.

37. The TAP formally closed in June 2015, at which point responsibility for remaining risks and actions was transferred to Revenue Scotland's operational team. Internal and external reviews of the programme took place during June and July 2015 and identified lessons learned. Revenue Scotland is disseminating these lessons through presentations to a range of interested parties, including:

- directors and senior officials in the Scottish Government, including those involved in welfare reform programmes
- members of the Scottish Government's Smith Commission Fiscal Implementation Board (paragraph 59)
- colleagues in the Welsh Government, who are preparing for Landfill Tax and Stamp Duty Land Tax to be devolved there in April 2018.

Revenue Scotland is developing arrangements to monitor and report its performance

38. Revenue Scotland has developed 16 indicators to help it assess its performance relative to the four principles of taxation on which its approach is founded: certainty, convenience, efficiency and proportionality to the ability to pay.[15] Taken together, these indicators will help to provide a picture of how effectively Revenue Scotland is fulfilling its tax collection role.

39. Revenue Scotland reports performance information publicly. It reports annually on ten of its indicators and quarterly on six. By November 2015, it had published two sets of quarterly data on its website, covering the period April to September 2015.[16] This provided information on the:

- number and percentage of tax returns submitted online (98 per cent)
- number and percentage of tax payments received on time (92.5 per cent)
- number of calls received and call waiting times
- number of written communications from taxpayers and response times
- number of complaints (3)
- number of security breaches (0).

40. From 2016, Revenue Scotland will prepare an annual report that provides an overview of its activities, including how it is performing against all of its objectives and indicators.

41. Revenue Scotland is continuing to develop its arrangements for monitoring and reporting performance. The Chief Executive of Revenue Scotland reports to the board on operational matters at its monthly meetings. Currently, the senior management team receives a range of information at different times, including reports on Revenue Scotland's expenditure, total tax received and due, compliance activity and performance against its indicators. Revenue Scotland is working to make this process more systematic and to improve what and how information is reported.

Part 2

Scottish rate of income tax

Key messages

1 The Scottish Government and HMRC are working well together in preparing for the introduction of the Scottish rate of income tax in April 2016. Plans for HMRC's communication with Scottish taxpayers have been revised to reflect the timing of the Scottish Government's budget.

2 The estimated cost range of setting up the Scottish rate of income tax has decreased by £10 million, to between £30 million and £35 million. This is due to a reduction in estimated non-IT costs, which includes the costs of writing to Scottish taxpayers and publicising the changes to income tax.

The Scottish Government and HMRC are working well together in preparing for the introduction of the Scottish rate of income tax

42. From April 2016, the Scottish Parliament will set a Scottish rate of income tax (SRIT). The main UK rates of income tax will be reduced by ten pence for each tax band for Scottish taxpayers. Each year, the Scottish Parliament will vote to approve the Scottish rate to be added to the reduced UK rates. Taxes raised by the SRIT will be added to the Scottish Government's budget and a corresponding reduction will be made to the block grant. The block grant is the funding that the Scottish Government receives from the UK Government every year.

> from April 2016, the Scottish Parliament will set a Scottish rate of income tax

43. HMRC will collect and administer the SRIT and is responsible for the project to implement it. The Scottish Government is responsible for funding this project and ensuring that the cost of the SRIT represents value for money and for seeking assurances that the new system will collect the correct amount of tax. The Scottish Government is working closely with HMRC to prepare for the SRIT and this arrangement is working well.

44. During 2015, HMRC's project to implement the SRIT has continued to make progress. The main areas of work have been:

- identifying Scottish taxpayers
- modifying the existing IT system in HMRC and testing the new versions
- communicating changes to stakeholders, such as tax advisers, pension providers and employers
- developing processes for compliance and enforcement.

45. The National Audit Office (NAO), which audits HMRC, reported in November 2015 on progress in implementing the SRIT.[17] It reported that HMRC's SRIT project is subject to a sound governance process, and that HMRC is engaging proactively with the Scottish Government. The NAO highlighted that HMRC's relationship with the Scottish Government has allowed timely challenge throughout the project, and has also allowed a greater level of scrutiny of the costs incurred by HMRC in relation to the SRIT project. The NAO also reported that HMRC has developed a clear and detailed compliance strategy. It has yet to confirm the exact nature of the compliance activity it will undertake from April 2016.

46. The Auditor General provides the Scottish Parliament with additional assurance on the NAO's audit work on the SRIT. As part of these arrangements the Auditor General took a report to the Scottish Parliament in November 2015.[18] This stated that the Auditor General was satisfied that the NAO’s approach was sufficient and robust, that its audit work covered the key audit risks, and that the findings and conclusions were reasonably based.

47. In our previous report, we recommended that the Scottish Government should review staffing devoted to the SRIT project.[19] To reflect the increasing demands in the run-up to introducing the SRIT, the Scottish Government has allocated two additional people to its SRIT team. It now has three members of staff, which more adequately reflects its workload. This team can draw on additional support from other areas of the Scottish Government, including the IT, procurement and communications directorates.

48. In preparing for the SRIT, HMRC and the Scottish Government are considering the implications of the further powers over income tax outlined in the Scotland Bill 2015 (Exhibit 1, page 6).

Plans for HMRC's communication with Scottish taxpayers have been revised to reflect the timing of the Scottish Government's budget

49. Communicating with Scottish taxpayers about the introduction of the SRIT is a major part of HMRC's project during 2015/16 and will account for most of the non-IT costs (paragraph 53). In December, HMRC plans to send a letter to people it has identified as Scottish taxpayers asking them to respond only if they disagree with their tax status. A media campaign will be launched around the same time.

50. The UK Government published the outcome of its spending review on 25 November 2015. This included the amount of funding that the Scottish Government will receive by way of block grant. The Scottish Government decided not to publish its draft budget for 2016/17, including the proposed rate for the SRIT, until after this. Consequently, HMRC's communication with Scottish taxpayers will not be able to illustrate the financial impact of the SRIT as intended. The NAO reported that this leaves an increasingly narrow timeframe for HMRC to react to responses from taxpayers and refine its taxpayer data before the SRIT begins in April 2016.[20]

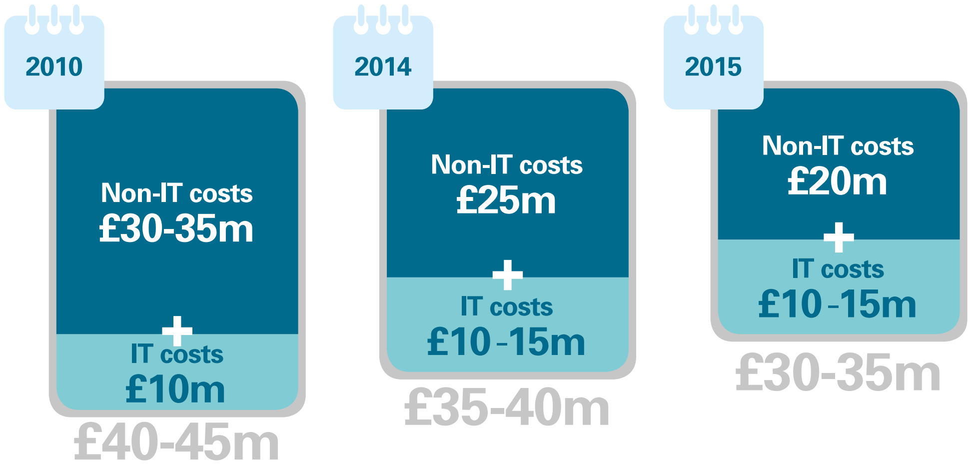
The estimated cost of setting up the Scottish rate of income tax has decreased further

51. The Scottish Government is responsible for meeting HMRC's costs in setting up and operating the SRIT. The estimated set-up costs continue to be revised as HMRC progresses its implementation project.

52. In December 2014, we reported that the original estimated set-up costs had been revised downwards, from between £40 million and £45 million to between £35 million and £40 million. These estimates have decreased further, to between £30 million and £35 million (Exhibit 5). The Scottish Government plans to include further updated cost estimates in its draft budget for 2016/17.

Exhibit 5
Estimated set-up costs for the Scottish rate of income tax

The estimated cost range of setting up the Scottish rate of income tax has decreased by £10 million, owing to the downward revision of non-IT costs.



Source: *Third annual report on the implementation and operation of part 3 (financial provisions) of the Scotland Act 2012*, UK Government, March 2015

53. The majority of non-IT costs (£16.3 million) are for HMRC's communication about the SRIT, such as writing to Scottish taxpayers and publicising the changes to income tax. The remaining £3.7 million is for project delivery costs. The £5 million reduction in estimated non-IT costs between 2014 and 2015 is due mainly to a decision by HMRC's SRIT project board to write to people only once about their Scottish taxpayer status. This has reduced cost estimates by around £4.5 million.[21]

54. IT costs reflect changes to HMRC's existing systems to allow for:

- Scottish taxpayers to be identified separately and to tax them at a different rate (estimated cost of £10 million)
- work to bring in changes to the pensions tax relief system, due in 2018 (estimated cost of £5 million).

55. To date, HMRC has charged the Scottish Government around £2.7 million for implementing the SRIT (£0.17 million in 2012/13; £0.79 million in 2013/14 and £1.74 million in 2014/15). Most set-up costs are expected to be incurred during 2015/16. The Scottish Government included £25.7 million in its budget for 2015/16 to implement the financial powers in the Scotland Act 2012, including the SRIT. It expects to pay a further £10 million in set-up costs during 2016/17 and 2017/18.[22] The Department of Work and Pensions (DWP) has assessed the impact of the SRIT on its services. It is identifying the cost of changes it needs to make to its systems and guidance to accommodate the introduction of the SRIT. DWP will charge the Scottish Government for these costs.

56. HMRC has reviewed its estimate of £4.2 million a year to administer and collect the SRIT. In October 2015, it estimated that running costs would be between £2 million and £2.5 million if the Scottish Parliament sets the Scottish rate at ten pence, and that they would be between £5.5 million and £6 million if the rate was anything other than ten pence.[23] The Scottish Government is working with HMRC to identify the management information HMRC will provide once the SRIT has been introduced. Operating costs will be reported in an extract from HMRC's accounts, which will be audited by the NAO and laid annually in the Scottish Parliament (paragraph 76).

Part 3

Financial management and reporting

Key messages

1. The Scottish Government established its Fiscal Capability 2015 Programme to oversee the introduction of the new financial powers in the Scotland Act 2012. It has made good progress in modifying its existing arrangements to accommodate the new powers.

2. Some arrangements to manage the powers beyond 2015/16 are still being developed. The Scottish and UK Governments have yet to agree the terms of the block grant adjustment for the devolved taxes after 2015/16. The Scottish Government is developing longer-term arrangements for capital borrowing and accounting arrangements for the devolved taxes and capital borrowing. This is a reasonable approach, given that the fiscal framework is yet to be agreed with the UK Government. These are important elements of sound financial management that will need to be fully developed quickly following agreement of the framework.

the environment for Scotland's public finances is undergoing fundamental change

57. The environment for Scotland's public finances is undergoing fundamental change. The new financial powers set out in the Scotland Act 2012 have started to take effect, and the Scotland Bill 2015 includes proposals for further financial devolution (Exhibit 1, page 6). The Scottish Government is implementing and managing the financial powers in the Scotland Act 2012 in the context of further financial devolution. A new fiscal framework is being agreed between the Scottish and UK Governments and aims to provide the Scottish Government with the tools to manage the powers in the Scotland Bill 2015 within the overarching UK fiscal framework.[24]

The Scottish Government has developed clear structures for overseeing the introduction of new financial powers

58. The Scottish Government's Fiscal Responsibility Steering Group oversees work programmes that are managing preparations for new financial powers (Exhibit 6, page 21). This included the Tax Administration Programme for the devolved taxes until it closed in June 2015 (see Part 1), the Fiscal Capability 2015 Programme for other Scotland Act 2012 powers, and the Smith Commission Fiscal Implementation Programme. These arrangements help ensure that the Scottish Government's work to implement new financial powers is coordinated.

Exhibit 6

Arrangements to manage the introduction of new financial powers

The Scottish Government has established clear structures for overseeing the introduction of new financial powers.

Fiscal Responsibility Steering Group

Tax Administration Programme

CLOSED: JUNE 2015

Devolved taxes

Set up: early 2013

Remit: to set up Revenue Scotland and the arrangements for collecting the devolved taxes

Fiscal Capability 2015 Programme

Scotland Act 2012

Set up: May 2014

Due to close: April 2016

Remit: to oversee the implementation of devolved fiscal powers, except the parts covered by the Tax Administration Programme

Smith Commission Fiscal Implementation Programme

Scotland Bill 2015

Set up: March 2015

Remit: to develop arrangements and oversee the implementation of the financial provisions of the Smith Agreement and the Scotland Bill 2015

Financial and Commercial Communications and Capability Programme

Staff and skills

Set up: 2014

Remit: to ensure the Scottish Government has the right number of staff with appropriate financial and commercial skills

Source: Scottish Government

59. The Scottish Government established the Fiscal Capability 2015 Programme in May 2014 to manage preparations for the new financial powers in the Scotland Act 2012. This includes reviewing and amending its financial management procedures, accounting systems and budget monitoring arrangements. Most elements of the Fiscal Capability 2015 Programme are now complete, and this programme will end following the introduction of the SRIT in April 2016. The Smith Commission Fiscal Implementation Programme oversees preparations for the financial powers proposed in the Scotland Bill 2015 and the development of an updated fiscal framework.

60. The Scottish Government plans to provide information on the financial powers introduced by the Scotland Act 2012 in its draft budget for 2016/17. This includes tax receipt forecasts: that is, estimates of how much the devolved taxes and the SRIT will raise, the rates and assumptions the forecasts are based on and the impact on the block grant. It will also include any plans to borrow money for capital investment. The draft budget will be published later than usual, to reflect the timing of the UK Government's spending review (paragraph 50). This will reduce the time available for the Scottish Parliament to scrutinise the draft budget. In response, the Finance Committee has requested information in advance of publication of the draft budget. For example, it has asked the Scottish Fiscal Commission (SFC) (paragraph 77) to provide commentary on the Scottish Government's forecasts of devolved tax receipts for 2015/16, relative to available figures on actual tax receipts.

Some arrangements to manage the new financial powers beyond 2015/16 are still being developed

61. The Scottish Government is incorporating the financial aspects of the new powers within its financial management procedures and has made good progress. Some arrangements for 2016/17 onwards are still being developed and are being considered within the context of further financial devolution. It is reasonable for the Scottish Government to wait to fully develop these arrangements until it has agreed a new fiscal framework with the UK Government.

62. The Scottish and UK Governments have yet to agree the terms of the block grant adjustment for the devolved taxes after 2015/16. In addition, the Scottish Government is developing longer-term arrangements for capital borrowing and accounting arrangements for the devolved taxes and capital borrowing.

The UK and Scottish Governments have yet to agree a permanent mechanism for the adjustment to the block grant for the devolved taxes

63. In January 2015, the UK and Scottish Governments agreed the block grant adjustment (BGA) for the two devolved taxes for 2015/16. The adjustment of £494 million is an average of the Scottish Government and UK Office for Budget Responsibility forecasts of how much would have been raised in 2015/16 had the UK Stamp Duty Land Tax and Landfill Tax continued to be collected in Scotland. Ministers are yet to agree a permanent mechanism for adjusting the block grant in future years. This is being considered as part of work to update the fiscal framework.

64. Alongside negotiations about the BGA, the Scottish and UK Governments are discussing an amount for what is known as forestalling activity when LBTT was introduced. This is to reflect the likelihood that some Scottish housing transactions were brought forward to before 1 April 2015, because of differences in UK and Scottish tax rates. This may have resulted in the UK Government gaining additional revenues in 2014/15 that would otherwise have been collected by Revenue Scotland in 2015/16 and paid into the Scottish Consolidated Fund.

65. In January 2015, the Scottish Government forecasted that it would raise £381 million in LBTT (excluding forestalling effects) and £117 million in SLfT in 2015/16. The Scottish Government planned its 2015/16 expenditure on the premise that it will achieve the forecasted level of tax receipts. It monitors actual receipts received during the year. Scottish Government and Revenue Scotland finance staff meet regularly and the latest position for both devolved taxes is provided monthly to Scottish ministers. Revenue Scotland received tax returns for transactions totalling £218 million in LBTT in the first seven months of 2015/16, and £37.4 million in SLfT in the first three months. The SFC will provide a commentary on actual receipts compared to forecasts to support the Scottish Parliament's scrutiny of the draft budget for 2016/17.

66. The Scottish Government will manage variations in devolved tax receipts alongside other in-year budgetary pressures using its well-established budget management procedures. Under current arrangements, the Scottish Government can manage any shortfall in devolved tax receipts by spending less money, borrowing money or using its cash reserve. It can borrow up to a total of £200 million a year (up to an overall total of £500 million) from HM Treasury with repayment due within four years. The Scottish Government has agreed procedures for using this facility with the Scotland Office and HM Treasury, should it decide to use it. If devolved taxes raise more than forecast, the Scottish Government can spend the excess or pay it into a cash reserve. Currently, the limit on the cash reserve is £125 million and the Scottish Government may only access it to meet any future shortfall in tax receipts. Discussions continue between the UK and Scottish Governments on the operation of the cash reserve, as part of the development of a new fiscal framework.

The Scottish Government is developing processes to manage its capital borrowing powers

67. New capital borrowing powers in the Scotland Act 2012 took effect on 1 April 2015. They allow the Scottish Government to borrow up to ten per cent of its capital budget each year for capital investment, with a total limit of £2.2 billion.

68. The Scottish Government set out its intentions to borrow the maximum amount available, £304 million, in its 2015/16 draft budget.[25] This decision was taken in the context of the Scottish Government's existing infrastructure and investment strategy. The Scottish Government intends to manage its capital borrowing within the five per cent affordability limit that it has set for long-term investments. This aims to ensure that annual revenue payments relating to capital investment are within five per cent of its total annual Departmental Expenditure Limit (DEL) budget. DEL is the majority of the Scottish Government's capital and revenue budget, which covers programme spending and running costs.

69. Under the 2012 Act, the Scottish Government has the power to borrow from the National Loans Fund (NLF), commercial banks or through issuing bonds. As part of the Fiscal Capability 2015 Programme, the Scottish Government has arranged a capital borrowing facility with the NLF, although consideration of other financing options is ongoing.

70. For 2015/16, the Scottish Government plans to draw down borrowing towards the end of the financial year. This is intended to minimise interest costs in the current financial year, and allow final decisions about the total amount borrowed to reflect the most accurate forecasts of capital spending. Scottish ministers will have to make important decisions about the timing of borrowing and the amount borrowed. Information from existing capital budget monitoring procedures will help to inform these decisions. The term of the loan and repayment method will have implications for the Scottish budget as interest costs and capital repayments will need to be met through the revenue budget.

71. The Scottish Government recognises the need for a strategy for borrowing. This is currently being developed and, following an agreement on the updated fiscal framework, it should be progressed as a priority to help support future decisions on capital borrowing.

72. The Scottish Government has officials in post with the necessary knowledge of capital borrowing but recognises that current resources need to be supplemented, either through targeted recruitment or specialised training. The need for more staff and specific skills in other areas is likely to arise as further financial powers are devolved.

The Scottish Government is developing its accounting and financial reporting arrangements for the devolved taxes and capital borrowing

73. The Fiscal Capability 2015 Programme includes consideration of how and where devolved tax receipts and capital borrowing liabilities should be accounted for and reported. This is being taken forward as part of a separate project to develop public sector financial reporting. Tax receipts and borrowing liabilities are likely to be reported in the Scottish Government Consolidated Accounts, the Scottish Consolidated Fund account and accounts of the devolved taxes prepared by Revenue Scotland. The Scottish Government will need to ensure that reporting is consistent, transparent and in line with public sector financial accounting frameworks.[26] It should progress its financial reporting arrangements for these powers as a priority.

The Scottish Parliament will scrutinise extracts of HMRC's accounts relating to the Scottish rate of income tax

74. The Scottish Government is expected to announce the tax rate for the SRIT in its draft budget for 2016/17. It plans to include forecasts of receipts from the SRIT and details of the impact on the block grant.

75. HMRC continues to produce forecasts of revenues from the SRIT on behalf of the Office for Budget Responsibility. It published its latest estimates in November 2015, which assume a ten pence tax rate. It forecasts receipts of £4.9 billion in 2016/17.[27] In the Scottish Fiscal Commission Bill (paragraph 77), the Scottish Government proposes a statutory duty for the SFC to provide assurance on Scottish ministers' forecasts of receipts from the SRIT.

76. Spending and receipts relating to the SRIT will be identified separately in HMRC's accounts, which the NAO audits. Each year, HMRC will provide the relevant audited extracts of its accounts to the Scottish Parliament for scrutiny. The first extract from HMRC's resource accounts, which shows the costs relating to the set-up and collection of the SRIT, was provided to the Scottish Parliament in November 2015. The first extract from HMRC's trust statement, showing the tax collected through the SRIT in 2016/17, is likely to be considered by the Scottish Parliament in the second half of 2017. Final receipts for 2016/17 will be reported in the extract from the trust statement published in 2018, as payments for self-assessed taxes will continue to be collected after the end of the tax year.

The Scottish Government intends to establish the Scottish Fiscal Commission on a statutory basis

77. The Scottish Government set up the SFC as an independent body in 2014 to review and report on its forecasts of tax revenues. The SFC is an important part of the scrutiny process. Its reports are intended to provide the Scottish Parliament and taxpayers with independent assurance that the forecasts are soundly based and reasonable. Following a consultation, the Scottish Government introduced the Scottish Fiscal Commission Bill in September 2015.

78. The Scottish Government proposes to establish the SFC as a corporate body that will have the status of a non-ministerial department. This means it would be directly accountable to the Scottish Parliament for delivering its functions, rather than through ministers. Scottish ministers propose to make appointments to the SFC following an open public appointments process, with approval by the Scottish Parliament. Although these proposals provide a significant degree of independence from the Scottish Government, this could be increased by moving the balance of influence on appointments further towards the Scottish Parliament. In particular, it may increase the public perception of independence further if the members of the SFC were appointed by Parliament with the agreement of ministers.

79. The proposed statutory functions of the SFC include publishing reports setting out its assessment of Scottish ministers' forecasts of:

- receipts from devolved taxes
- receipts from income tax attributable to a Scottish rate
- borrowing requirements
- assumptions of the economic factors supporting forecasts of receipts from non-domestic rates.

80. To better support the Scottish Parliament in its scrutiny of the Scottish Government's budgets, it is important that the SFC provides an overall commentary bringing together the results of each of these individual assessments and commenting on their overall effect. One of the proposed future functions of the SFC set out in the Scottish Government's consultation on the draft bill was the assessment of the mechanisms for adjusting the block grant, to reflect the prospect of further financial devolution.[28] Given that mechanisms are required to be in place under the existing Scotland Act 2012 fiscal devolution arrangements, it may be appropriate to incorporate this function in the SFC's remit. The assessment of mechanisms for adjusting the block grant should include the operation of the Barnett formula.

81. The Scottish Government expects that the SFC's remit will grow in line with further financial devolution. The proposed statutory functions in the draft bill would accommodate further devolution of individual taxes and borrowing. Scottish ministers have committed to provide the SFC with the funding it needs to discharge its functions, through the Scottish budget. The financial memorandum to the Bill estimates costs of £850,000 a year. The amount of funding the SFC would require would likely increase with any additional responsibilities. It is important that the SFC has sufficient staff and budget to carry out its role effectively. The independence and impartiality of the SFC would be enhanced if it were funded through the Scottish Parliament's budget rather than the Scottish Government's budget.

Endnotes

1 *Update on developing financial reporting* [PDF], Audit Scotland, March 2015.

2 Ibid.

3 *Report of the Smith Commission for further devolution of powers to the Scottish Parliament*, Smith Commission, November 2014.

4 *Preparations for the implementation of the Scotland Act 2012* [PDF], Audit Scotland, December 2014.

5 *Managing ICT contracts in central government: an update* [PDF], Audit Scotland, June 2015.

6 *Preparations for the implementation of the Scotland Act 2012* [PDF], Audit Scotland, December 2014.

7 *Revenue Scotland key performance indicators: April to June 2015 and July to September 2015*, Revenue Scotland.

8 *Corporate plan June 2015 - March 2018*, Revenue Scotland, June 2015.

9 *Preparations for the implementation of the Scotland Act 2012* [PDF], Audit Scotland, December 2014.

10 *Implementation of the devolved taxes: written submission from Revenue Scotland to the Public Audit Committee and Finance Committee*, Revenue Scotland, 27 February 2015.

11 *Revenue Scotland and Tax Powers Bill: financial memorandum*, Scottish Government, December 2013.

12 *The 2015/16 autumn budget revision*, Scottish Government, November 2015.

13 *Revenue Scotland key performance indicators: April to June 2015 and July to September 2015*, Revenue Scotland.

14 *HM Revenue and Customs 2014/15 accounts: report by the Comptroller and Auditor General*, National Audit Office, July 2015.

15 *Corporate plan June 2015 - March 2018*, Revenue Scotland, June 2015.

16 *Revenue Scotland key performance indicators: April to June 2015 and July to September 2015*, Revenue Scotland.

17 *The administration of the Scottish rate of income tax 2014/15*, National Audit Office, November 2015.

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19 *Preparations for the implementation of the Scotland Act 2012* [PDF], Audit Scotland, December 2014.

20 *The administration of the Scottish rate of income tax 2014/15*, National Audit Office, November 2015.

21 *Third annual report on the implementation and operation of part 3 (financial provisions) of the Scotland Act 2012*, UK Government, March 2015.

22 *Scottish Government third annual report on the implementation and operation of part 3 (financial provisions) of the Scotland Act 2012*, Scottish Government, March 2015.

23 *HMRC update on the Scottish rate of income tax*, Finance Committee, 28 October 2015.

24 *Report of the Smith Commission for further devolution of powers to the Scottish Parliament*, Smith Commission, November 2014.

25 *Draft budget 2015/16*, Scottish Government, October 2014.

26 *Update on developing financial reporting* [PDF], Audit Scotland, March 2015.

27 *Economic and fiscal outlook: devolved taxes forecast*, Office for Budget Responsibility, November 2015.

28 *A consultation on the Scottish Fiscal Commission*, Scottish Government, March 2015.

Appendix

Audit methodology

We reviewed a range of information during our audit, including the following:

- Papers from the Scottish Parliament Finance Committee and Public Audit Committee
- The Scottish and UK Government's third annual reports on progress in implementing the Scotland Act 2012
- Papers and minutes from the Revenue Scotland Board and Audit and Risk Committee
- Papers and minutes from the Scottish Government's Tax Administration Programme
- Papers and minutes from the Scottish Government's Fiscal Capability 2015 Programme.

We spoke to representatives from:

- Scottish Government
- Revenue Scotland[1]
- Registers of Scotland
- Scottish Environment Protection Agency.

We considered the National Audit Office's planning and approach to its audit work on the Scottish rate of income tax:

We reviewed the NAO's documentation and the basis for its findings and conclusions. In particular, we considered:

- the NAO's approach to identifying the key risks to the successful implementation of the SRIT
- the NAO's audit working files, with particular focus on the audit evidence underpinning the key findings and conclusions in its report
- the NAO's arrangements for ensuring the quality of the audit work and reporting.

Note: 1. On 1 January 2015, Revenue Scotland became a non-ministerial department in the Scottish Administration. It is headed by the board of Revenue Scotland, which is responsible for the leadership and direction of the organisation. The Auditor General for Scotland has appointed Audit Scotland as Revenue Scotland's external auditors. The first year of audit is 2015/16, which will involve auditing Revenue Scotland's accounts and aspects of its governance arrangements, systems and processes. This report focuses on Revenue Scotland's role in implementing and collecting the Land and Buildings Transaction Tax (LBTT) and the Scottish Landfill Tax (SLfT).

Implementing the Scotland Act 2012

An update

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Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN
T: 0131 625 1500 E: info@audit-scotland.gov.uk
www.audit-scotland.gov.uk

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