THIRD ANNUAL REPORT ON THE IMPLEMENTATION AND OPERATION OF PART 3 (FINANCIAL PROVISIONS) OF THE SCOTLAND ACT 2012

Third Annual Report on the Implementation and Operation of Part 3 (Financial Provisions) of the Scotland Act 2012

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FOREWORD

Since the publication of the second Annual Report on the implementation of the powers contained within the Scotland Act 2012 in May last year, people in Scotland have made one of the most important collective decisions of their lifetimes.

On 18th September 2014, Scotland voted decisively to stay part of the United Kingdom. In the run up to the referendum, the leaders of the three main pro-UK; the Conservatives, Liberal Democrats and Labour, all made a vow to devolve further powers to strengthen the Scottish Parliament within the United Kingdom – ensuring that Scotland would retain the best of both worlds.

In keeping with the vow, the day after the referendum the Prime Minister announced that Lord Smith of Kelvin had agreed to lead a Commission to agree what those new powers should be. The five parties in the Scottish Parliament participated in the Smith Commission, the first time that all five have participated in a devolution process.

The Commission invited submissions from political parties, a wide range of business and civic organisations and the wider public to help guide its consideration of what further powers should be devolved to the Scottish Parliament. Following due consideration of all submissions and views garnered by the Commission, on 27th November 2014, the report detailing the Heads of Agreement agreed by all five parties was published.

That report was welcomed by this Government, and on 22nd January 2015 we published the draft clauses which will make up the substance of the new Scotland Bill to implement the recommendations of that report. Whoever forms the next Government after the May 2015 General Election will take forward this legislation in the next Parliament.

At the same time that we are working to devolve these further powers to the Scottish Parliament, we are continuing to honour our earlier commitment to the people of Scotland. In 2010 this Government made a commitment to people in Scotland to deliver the recommendations of the Calman Commission in our Programme for Government.

The recommendations of the Calman Commission were delivered through the Scotland Act 2012 which increases the financial flexibility and accountability of the Scottish Parliament and Government to people in Scotland. That Act saw the greatest devolution of financial powers since the creation of the United Kingdom over 300 years ago.

I am pleased to have been involved in the continued implementation of the Scotland Act 2012 which demonstrates the effective delivery of the powers promised. This report sets out in detail the progress made this year to devolve the remaining financial provisions of the Scotland Act 2012.

This Government has made the necessary legislation to fully devolve Stamp Duty Land Tax and UK Landfill Tax in Scotland from 1st April 2015. This legislation paves the way for the Scottish Government's introduction of Land and Buildings Transaction Tax and Scottish Landfill Tax.

Work also continues in preparation for the introduction of the Scottish rate of Income Tax in 2016. Changes to the relevant IT systems have been made; we continue to work with the Scottish Government to improve the identification of Scottish taxpayers; and, we are engaging widely with all relevant people, particularly employers and pension providers, to seek feedback and ensure everyone is kept up-to-date on all the developments made.

The work carried out to implement the Scotland Act 2012 proves the commitment of Scotland's two governments to make the devolution settlement work.

Alistair Carmichael.

Rt Hon. Alistair Carmichael MP

Secretary of State for Scotland

CHAPTER 1

INTRODUCTION

Scope and Content of this Report

1. This report on Part 3 of the Scotland Act 2012 is the third published since the Act gained Royal Assent on 1 May 2012.

2. Part 3 of the Scotland Act 2012 deals exclusively with the devolution of financial powers. These include:
   - the creation of a new Scottish rate of Income Tax;
   - the disapplication of UK Stamp Duty Land Tax in Scotland and provision for the introduction of a new Scottish tax on land transactions;
   - the disapplication of UK Landfill Tax in Scotland and provision for the introduction of a new Scottish tax on disposals to landfill;
   - provision for borrowing by Scottish Ministers; and
   - the power to create new devolved taxes.

3. The financial provisions will be implemented over a number of years, in line with the timetable set out in the Command Paper which accompanied the publication of the Scotland Bill in November 2010, to ensure that appropriate transitional arrangements are put in place. In order that both the UK and Scottish Parliaments are fully informed through this process, section 33 of the Scotland Act 2012 requires the Secretary of State for Scotland and Scottish Ministers to report annually on the implementation of this part of the Act.

4. Both Parliaments will be sighted on the views of both administrations: the Secretary of State for Scotland is required to report to the UK Parliament and provide a copy to Scottish Ministers who are required to lay it before the Scottish Parliament; and Scottish Ministers are required to report to the Scottish Parliament and provide a copy to the Secretary of State, who is required to lay it before both Houses of Parliament at Westminster. Both Governments will continue to report until April 2020, or the first anniversary of

the day on which the last provisions of Part 3 come into force, if that is after April 2020.

5. Section 33(5) of the Scotland Act 2012 requires the annual reports to contain:
   (a) *a statement of the steps which have been taken, whether by the maker of the report or by others, since the making of the previous report (or, in the case of the first report, since the passing of this Act) towards the commencement of the provisions of this Part,*

   (b) *a statement of the steps which the maker of the report proposes should be taken, whether by the maker of the report or by others, towards the commencement of the provisions of this Part,*

   (c) *an assessment of the operation of the provisions of this Part which have been commenced,*

   (d) *an assessment of the operation of any other powers to devolve taxes to the Scottish Parliament or to change the powers of the Scottish Ministers to borrow money, and of any other changes affecting the provisions inserted or amended by this Part,*

   (e) *the effect of this Part on the amount of any payments made by the Secretary of State under section 64(2) of the 1998 Act (payments into the Scottish Consolidated Fund), and*

   (f) *any other matters concerning the sources of revenue for the Scottish Administration (within the meaning of section 126(6) of the 1998 Act) which the maker of the report considers should be brought to the attention of the Parliament of the United Kingdom or the Scottish Parliament.*

6. *Annex A* provides a detailed list of the paragraphs in the report which address each of these requirements. However, the report is not limited to these requirements, and can also contain any other matters that each Government believes to be relevant or useful to both parliaments.

CHAPTER 2

SCOTLAND ACT 2012 IMPLEMENTATION PROGRAMME

Implementation of the Scottish rate of Income Tax and disapplication of Stamp Duty Land Tax and Landfill Tax in Scotland is delivered by HMRC through separate projects with oversight and governance provided by the Scotland Act 2012 implementation programme. The programme board includes representatives from HMRC, HM Treasury, the Scotland Office and the Scottish Government. Programme board members are involved in decision making to ensure that the projects deliver effective solutions and value for money.

Steps taken towards implementation since previous report

7. Major programmes and projects in central government are subject to OGC (Office of Government Commerce) Gateway™ Reviews, which provide assurance of the key stages so they can progress successfully to the next stage. In May 2014, the OGC undertook a Gateway 0 strategic assessment of the Scotland Act 2012 implementation programme which received an overall assessment of likely successful delivery of the programme. The review commented positively on the continued high level engagement with the Scottish Government. This followed a similar review in July 2013 in which the programme received the same rating.

8. Further external assurance reviews of the implementation programme will take place over its lifecycle and a further OGC review is expected to be undertaken by the summer of 2015.

9. A joint approach to managing the successful transition of the devolved taxes has been developed with HMRC working closely with the Scottish Government and Revenue Scotland[1].

[1] The Revenue Scotland and Tax Powers Act 2014 received Royal Assent on 24 September 2014 and established Revenue Scotland as the tax authority responsible for the collection and management of devolved taxes. The UK Government passed The Revenue Scotland and Tax Powers Act 2014 (Consequential Provisions and Modifications) Order 2014 in consequence of that Act to establish Revenue Scotland as a Non-Ministerial Department and as an office-holder in the Scottish Administration.

10. The Statement of Funding Policy sets out the principle that the devolved administrations will meet all the operational and capital costs associated with devolution from within their allocated budgets[2]. Information about the costs passed onto the Scottish Government as a result of the programme and individual projects is provided in the relevant sections of this report. Additionally, the UK Government committed to transferring to the Scottish Government the costs saved by HMRC from no longer operating Stamp Duty Land Tax (SDLT) and Landfill Tax in Scotland. The gross annual cost savings for HMRC no longer operating SDLT and Landfill Tax in Scotland after April 2015 has been estimated at £275,000. There will also be a continuing maintenance cost of £18,000 a year for the IT changes that have been made to ensure that data on property transactions is available to HMRC, so the net amount of the saving is £257,000 a year. This information has been shared with the Scottish Government and the amount will be transferred from HMRC to the Scottish Government in the 2015-16 Main Estimates.

11. Edward Troup (HMRC's Tax Assurance Commissioner and Additional Accounting Officer for the Scottish rate of Income Tax) appeared before the Scottish Parliament's Finance Committee in May 2014 and January 2015 to report HMRC's progress on implementing the Scotland Act 2012.

12. HMRC is represented on Revenue Scotland's tax administration programme board, contributing to Revenue Scotland's development of systems to manage the devolved taxes.

13. Progress on the individual projects to implement the Scottish rate of Income Tax and disapply SDLT and Landfill Tax is covered in greater detail in chapters 3, 4 and 5 of this report.

[2] *The Statement of Funding Policy can be accessed at:* http://webarchive.nationalarchives.gov.uk/20101128153522/http://cdn.hm-treasury.gov.uk/sr2010_fundingpolicy.pdf

Further steps that will be taken towards implementation

14. In 2015-16, the programme will continue to provide oversight of the separate HMRC projects and the Board will meet regularly to consider progress towards implementation. HMRC has shared with the Scottish Government an estimate of approximately £26m for its work in 2015-16 to implement the programme and projects.

15. In the second annual report HMRC estimated that its implementation costs in 2014-15 would be in the region of £5-6m. HMRC has shared with the Scottish Government a reduced estimate of £2.6m for this work. The original estimate assumed that the costs for changes to HMRC's IT system to reflect introduction of the Scottish rate would be split equally across 2014-15 and 2015-16. A detailed examination of the work needed to make these changes has properly allocated the majority of this work in 2015-16 with an associated reduction in costs for 2014-15. In addition, some of the costs associated with the closure of HMRC's SDLT system and provision for the transfer of Scottish land and property data to HMRC will be properly incurred in 2015-16.

CHAPTER 3

SCOTTISH RATE OF INCOME TAX

From April 2016, the main UK rates of Income Tax will be reduced by 10 pence in the pound for those identified as Scottish taxpayers. The Scottish Parliament will set, in its annual budget, the new Scottish rate of Income Tax to be added to the reduced UK rates. The Scottish block grant will be adjusted to reflect this change in funding streams. Implementation of the Scottish rate is led by a HMRC project with representatives on the project board from HM Treasury, Scotland Office and the Scottish Government.

16. During 2014 HMRC has worked with its IT supplier to ensure that changes necessary to account for the Scottish rate are reflected in the specifications for the first phase of IT changes to be delivered in autumn 2015. These changes include the facility for HMRC to identify Scottish taxpayers separately on its systems ahead of contacting such taxpayers later in 2015, enable HMRC systems to respond to change of address notifications in real time to reflect Scottish taxpayer status and ensure customer information makes reference to the Scottish rate where that is necessary.

17. HMRC has continued to provide information to business about the implementation of the Scottish rate. Events in 2014 have included engagement with existing HMRC employer groups, pension providers and other representative bodies (including software providers) to raise awareness of the Scottish rate and how it will impact their employees, customers and systems. Initial customer research has been undertaken to test draft messages and guidance about Scottish taxpayer status and to understand how these need to address different circumstances. This information is helping HMRC develop its communication approach and inform the next stage of customer testing. Work has also started on preparing material to support HMRC staff to operate, and respond to questions about the Scottish rate.

18. HMRC has continued to develop the approach to identifying Scottish taxpayers so that the Scottish rate can be correctly applied to their income, in consultation with the Scottish Government.

19. The key to Scottish taxpayer identification is the location of an individual's main place of residence. If this is in Scotland for the majority of the tax year, an individual will be a Scottish taxpayer. HMRC hold complete addresses for the vast majority of UK resident taxpayers, which they use for correspondence purposes, and they will use these as a basis for the identification of Scottish taxpayers. HMRC has identified a risk that using these addresses, without further corroboration, might not provide sufficient confidence that the Scottish rate has been correctly applied, and has been exploring options to supplement its data with information from other sources.

20. HMRC's approach will involve UK wide HMRC data being compared with other data on residence (for example, the Scottish Electoral Register) to identify individuals who appear to live in Scotland, but for whom HMRC hold an address elsewhere in the UK. Once this scan has been completed, HMRC and Scottish Government will work together to agree a suitable and proportionate strategy which may include contacting these individuals. HMRC are examining other data sources to supplement their own data. As part of this, the Scottish Government has consulted on whether HMRC should be given access to NHS Scotland's address data.

21. Following this activity to improve the quality of HMRC address data, HMRC will write to customers who they believe to be Scottish taxpayers in autumn 2015. Alongside this, HMRC will be undertaking publicity to raise awareness of the Scottish rate throughout the UK. This will encourage taxpayers whose main place of residence is in Scotland, but who have not been contacted directly as part of the campaign, to notify HMRC of their correct address, and to remind taxpayers of the need to notify HMRC when they change their address.

22. Once this activity has been completed, in spring 2016, HMRC will issue PAYE tax codes to employers and pension providers as usual. Those applying to Scottish taxpayers will indicate that the Scottish rates should be used in relation to these employees.

23. A Technical Note setting out the Government's policy intentions in areas where the rate setting power interacts with other areas of the Income Tax system, was published in 2012, following consultation with representatives of relevant private sector groups. That note promised to publish legislative changes necessary to achieve these intentions for consultation before their being laid before Parliament. Some of the necessary amendments were made in Finance Act 2014 and HMRC published the remaining legislation for consultation[3] in December 2014.

24. The National Audit Office has begun to engage with HMRC ahead of their first report on HMRC's implementation and administration of the Scottish rate, which will be published before 31 January 2016.

Costs

25. The implementation of the Scottish rate of Income Tax remains on track. The 2014 annual report included overall estimated costs of £35m-£40m made up of non-IT costs of £25m and IT costs of £10m-£15m (against an original estimate of £40m-£45m). Following further work during 2014-15 to refine these figures, the overall implementation cost is now estimated to be in the region of £30m-£35m.

26. The non-IT costs are now estimated to be £20m, less than the previous estimate of £25m. This is made up as follows:

- £8.9m for issuing direct communications to Scottish taxpayers
- £3.7m for project delivery costs
- £4.2m for communications and publicity related activity

[3] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/389889/SRIT_Consequential_TechNote_vFinal.pdf

- £3.2m covers the remaining areas of impact and associated customer contact

27. The costs in the 2014 report included £4.45m for the production of PAYE coding notices to Scottish taxpayers, in addition to the initial notification letter advising individuals of their Scottish taxpayer status. Following discussions with Scottish Government, HMRC agreed to ensure that the notification letter includes sufficient information to advise customers of their change in tax status without the need for a separate coding notice. It was therefore agreed that separate coding notices need not be issued to Scottish taxpayers, leading to a saving of the £4.45m cost of this work. Additionally, a saving of around £0.5m in project costs has also been identified.

28. The remaining non-IT costs are largely driven by contact between HMRC and customers. HMRC have been undertaking a process of extensive customer research which will help to improve estimates of the volume of contacts and will review the estimate in the light of the results.

29. Further work has also been carried out to refine the estimate of IT costs. The majority of the cost is for amendments to HMRC's PAYE and Self Assessment systems to allow Scottish taxpayers to be identified separately and to build in the ability to tax their income at a different rate. The changes identified to these systems are estimated to cost £10m. Further work will also be required to accommodate changes to the pensions tax relief system, needed as a result of the Scottish rate. Ministers have agreed to a two year transitional period for the pensions industry, meaning these changes will be introduced in 2018. This work is currently estimated to cost up to £5m. Therefore, the previous estimate of £10m-£15m remains accurate.

30. Final figures for HMRC's costs arising in 2014-15 are not yet available. HMRC has so far invoiced the Scottish Government in 2014-15 for £1,178,707 for costs associated with the project and implementation programme and the total costs for 2014-15 are estimated to be £2.1m.

31. Further work has been undertaken in 2014-15 to improve the estimate for the annual running costs for the Scottish rate (currently estimated at £4.2m). Following this work, it has become clear that costs will increase in years when there is a change of rate and that they will remain higher during the period while the rates have diverged. This is because such a change is likely to increase customer contact and also provide an incentive for customers to try to artificially manipulate their Scottish taxpayer status to take advantage of different rates between Scotland and the rest of the UK. This work will continue during 2015-16.

32. In February 2014, the OGC undertook a strategic assessment which received an indication of likely successful delivery of the project. A follow up OGC review is due in early summer 2015.

Further steps that will be taken towards implementation 2015-16

33. This is a key year for the implementation of the Scottish rate, as HMRC needs to ensure that all the necessary systems and process changes are in place prior to April 2016. HMRC's IT supplier will undertake activity to deliver changes to HMRC's income tax system to implement the Scottish rate, including the ability to account for the Scottish rate and update customer address changes in real time. The IT change will be delivered on a phased basis, beginning in October 2015 – work on the Self Assessment system will take place during 2016-17 (as these changes are not required until April 2017) and the changes required to the pensions relief at source system will extend through to 2018-19. DWP will also make changes to their benefit systems to reflect the introduction of the Scottish rate.

34. As set out above, HMRC will also be contacting Scottish taxpayers from autumn 2015 to notify them of their liability to pay tax at the Scottish rate and give them an opportunity to correct their status if it is not correct. This notification is expected to be issued after the rate has been announced, which is expected to form part of the Scottish Budget announcement in the autumn. HMRC will then issue Scottish coding notices to employers and pension providers ahead of April 2016.

35. HMRC will continue to develop its approach to communicating information about the Scottish rate based on research findings to ensure those affected by the introduction of the Scottish rate have access to the information they need to understand what they need to do and where to get information. HMRC will continue to discuss communication options and associated costs, including customer contact and information campaigns, with the Scottish Government. As part of this, HMRC will continue to build on its existing engagements with employer and software provider groups. HMRC are aiming to begin employer communications activity from May 2015 and will use a range of channels as part of this approach. This is an important aspect of the work as, potentially, employers anywhere in the country could employ Scottish taxpayers during a year.

36. HMRC will update information for its staff to ensure guidance on the Scottish rate is in place. Work will also continue in developing HMRC's approach to compliance ensuring that options and associated costs are shared with the Scottish Government.

CHAPTER 4

SCOTTISH TAX ON LAND TRANSACTIONS

The Scotland Act 2012 provides for Stamp Duty Land Tax (SDLT) to be fully devolved to the Scottish Government from April 2015. SDLT will no longer apply to land transactions in Scotland. The Scottish Parliament will introduce Land and Buildings Transaction Tax to replace it. HMRC's SDLT project manages the requirements for successful transition to the new Scottish tax, including the switch-off of SDLT in Scotland. The project board includes representatives from HMRC and the Scottish Government. Board members are consulted and involved at key decision points to ensure that the project provides effective solutions and value for money.

Steps taken towards implementation since previous report

37. On 27 January 2015, John Swinney, the Scottish Government's Deputy First Minister and Cabinet Secretary for Finance, Constitution & Economy, wrote to David Gauke, the Financial Secretary to the Treasury, to confirm that Revenue Scotland would be ready for the transition from SDLT and Landfill Tax to the Land and Buildings Transaction Tax and Scottish Landfill Tax in April 2015. In order to facilitate this, UK Ministers laid a Treasury Order[4] before Parliament on 9 March 2015 to disapply SDLT in Scotland from 1 April 2015.

38. During 2014 HMRC worked closely with its external IT suppliers to develop the IT solutions for the devolution of SDLT and to challenge and refine the costs of implementing the project. The IT costs include changes to ensure returns for Scottish transactions from 1 April 2015 will be rejected by HMRC's system and provision for Revenue Scotland to supply HMRC with transactions data after 1 April 2015.

[4] The Scotland Act 2012, Section 29 (Disapplication of UK Stamp Duty Land Tax) (Appointed Day) Order 2015

39. All HMRC IT changes are on track for delivery to ensure successful transition to Land and Buildings Transaction Tax which will replace SDLT in Scotland from April 2015. The change to identify all Scottish transactions by the Local Authority code on the SDLT return has already been implemented and the IT channel for SDLT returns via Registers of Scotland has been decommissioned.

40. The 2014 annual report estimated the overall cost of this work to be around £1m and this remains the current working assumption. Final figures for HMRC's costs arising in 2014-15 are not yet available. HMRC has so far invoiced the Scottish Government in 2014-15 for £119,848 in respect of this work and the total costs for 2014-15 are estimated to be in the region of £470,000.

41. HMRC has continued to work with Revenue Scotland in developing joint communications including awareness events for those affected by the changes due in 2015. Joint approaches to communicating the changes are agreed between HMRC and Revenue Scotland, this has included the development of joint customer guidance which can be accessed from HMRC and Revenue Scotland websites.

42. In the last report HMRC estimated that the total cost included about £700,000 to £800,000 for IT changes to close HMRC's systems for Scottish transactions and provide a channel for Revenue Scotland to deliver Scottish transaction data to HMRC after April 2015 for wider tax compliance purposes. Final IT costs are not expected to exceed this estimate and the total cost of the SDLT project is not expected to exceed £1m. Of this, approximately £250,000 is expected to fall within 2015-16, for IT changes needed after April 2015 and for communications and business change activity required to embed the transition to Land and Buildings Transaction Tax.

43. HMRC has continued to support the Scottish Government and Revenue Scotland in developing its administrative framework for the Land and

Buildings Transaction Tax.

Further steps that will be taken towards implementation

44. HMRC will work with Revenue Scotland to agree principles for the relationship between the two authorities from April 2015. This will specify the roles and responsibilities with regard to exchange of information and areas of common interest including the transfer of information on Scottish transactions.

CHAPTER 5

SCOTTISH TAX ON DISPOSALS TO LANDFILL

The Scotland Act 2012 provides for Landfill Tax to be devolved. From April 2015, the UK tax will cease to apply in Scotland and the Scottish Parliament will replace it with Scottish Landfill tax. The UK tax will be 'switched off' and a corresponding adjustment will be made to the Scottish block grant. HMRC's Landfill Tax project manages the requirements for switch-off of Landfill Tax including impacts on the Landfill Communities Fund. The project board includes representatives from HMRC and the Scottish Government. Board members are involved in decision making to ensure that the project provides effective solutions.

Steps taken towards implementation since previous report

45. As set out in paragraph 37 above, in January 2015 the Scottish Government confirmed to the UK Government that Revenue Scotland would be ready for the transition from Landfill Tax to Scottish Landfill Tax. Therefore, a Treasury Order[5] was laid on 9 March 2015 to disapply Landfill Tax in Scotland from 1 April 2015.

46. As set out in last report due to the relatively small numbers of Landfill Tax operators affected by the changes being implemented any HMRC costs associated with the disapplication of Landfill Tax in Scotland will not be passed on to the Scottish Government.

47. During 2014, HMRC worked with Revenue Scotland on communicating the changes to Landfill Tax to ensure those affected are aware of the implications. This included information on the de-registration process for UK landfill operators, with sites in Scotland, and the registration process for the new Scottish Landfill Tax, with joint communications targeted at affected operators.

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[5] The Scotland Act 2012, Section 31 (Disapplication of UK Landfill Tax) (Appointed Day) Order 2015

HMRC will deregister landfill operators operating solely in Scotland after they have submitted their final returns covering the period ending 31 March 2015.

48. Draft legislation setting out the necessary changes to existing legislation for the disapplication of Landfill Tax and the Landfill Communities Fund in Scotland, including procedures for the two year transitional period for the Landfill Communities Fund, was laid on 10 March 2015.

Further steps that will be taken towards implementation

49. HMRC will work with Revenue Scotland to agree principles for the relationship between the two authorities from April 2015. This will specify the roles and responsibilities with regard to exchange of information and areas of common interest.

CHAPTER 6

BORROWING POWERS OF SCOTTISH MINISTERS

> *The provisions in the Scotland Act 2012 enable Scottish Ministers to borrow for three purposes from April 2015:*
>
> - *to deal with deviations between forecast and actual revenues, in addition to operating a cash reserve, Scottish Ministers can borrow up to £200m each year within a statutory limit of £500m. Loans will be for a maximum of 4 years;*
>
> - *to deal with temporary in-year shortfalls between receipts and expenditure, Scottish Ministers can borrow to provide the Scottish Consolidated Fund with an appropriate cash working balance. Note that a similar facility existed under the Scotland Act 1998; and*
>
> - *for capital investment, Scottish Ministers can borrow up to an additional 10% of the Scottish Government's capital DEL budget each year within a statutory limit of £2.2bn. Loans will be usually for a maximum of ten years but with the option of a longer period in line with the expected life of the asset;*

Steps taken towards implementation since previous report

50. The Scotland Act 2012 provides for the Scottish Government to borrow up to £2.2 billion for capital investment from the National Loans Fund and commercial banks from 2015-16. It also enables the UK Government to vary the means of capital borrowing through secondary legislation. The UK Government announced in February 2014 that it would use this power to enable Scottish Ministers to additionally issue bonds from 2015-16[6] .

51. In December 2014, the UK Government brought into force legislation[7] allowing the amendment of Scotland's borrowing powers. The relevant section of the Scotland Act 1998 inserted by this legislation has since been amended[8] so that Scottish Ministers are able to issue bonds to finance capital investment (within the existing borrowing limits) from 1 April 2015.

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[6] https://www.gov.uk/government/news/scotland-to-be-given-powers-to-issue-its-own-bonds
[7] The Scotland Act 2012 (Commencement No. 4) Order 2014
[8] The Scotland Act 1998 (Variation of Borrowing Power) Order 2015

CHAPTER 7

POWERS TO DEVOLVE FURTHER EXISTING TAXES AND CREATE NEW DEVOLVED TAXES

With the agreement of both governments, further existing taxes can now be devolved and the Scottish Parliament is able to introduce new Scotland-specific taxes. These powers support the ongoing evolution of devolved responsibilities and provide the Scottish Parliament with a new means of achieving policy outcomes, as well as potentially raising additional revenues.

52. This power came into force on the same date as the Scotland Act 2012. To date, neither the Scottish Government nor the UK Government has put forward proposals to create new devolved taxes under this power.

CHAPTER 8

EFFECT OF NEW POWERS ON THE SCOTTISH BLOCK GRANT

Since devolution in 1999, the Scottish Parliament has had almost complete flexibility over how it spends its income, the bulk of which has been provided in a block grant determined by the Barnett formula. As set out in the Command Paper published alongside the Scotland Bill, a fundamental principle of tax devolution is that an element of the block grant is exchanged for the ability to levy taxes. In order to ensure that the adjustment process is transparent and equitable, the UK and Scottish governments, through the Joint Exchequer Committee, have agreed a set of overarching principles as the basis for ***considering mechanisms for adjusting the block grant.***

Steps taken towards implementation since previous report

53. **In relation to Stamp Duty Land Tax (SDLT) and Landfill Tax**, the two Governments conducted a joint analysis of potential adjustment mechanisms during the summer of 2014. However, as the UK Government planned to reform SDLT in Autumn Statement 2014, it delayed agreement to ensure that the block grant adjustment didn't overstate the tax revenues foregone as a result of devolution. The reform is estimated to reduce the tax revenues foregone by the UK Government in 2015-16 by £80m, so the block grant deduction is therefore correspondingly smaller as a result. Following the reform, the UK Government proposed that an adjustment should initially be agreed for 2015-16 with a permanent adjustment mechanism considered as part of the new fiscal framework required under the Smith Agreement. On that basis the UK and Scottish Governments have agreed a block grant deduction for 2015-16 of £494 million, reflecting the average of the OBR and Scottish Government forecasts for the tax revenues foregone by the UK Government.

54. The UK Government and the Scottish Government have agreed to monitor the impact of any lag between the devolved taxes being implemented and the Scottish Government receiving the corresponding tax receipts. The UK Government is willing to provide cash management support at Supplementary Estimates if it is needed.

55. The two Governments are also considering the treatment of forestalling effects, which resulted from the Scottish Government's pre-announcement of Land and Buildings Transaction Tax rates and thresholds. Even though SDLT is being devolved as part of the Scotland Act 2012, rather than through the Smith Agreement, the UK Government is willing to consider the treatment of forestalling in line with the Smith Commission's principles around fairness.

Further steps that will be taken towards implementation

56. The two Governments will continue to work together to consider a permanent block grant adjustment mechanism for SDLT and Landfill Tax as part of the new fiscal framework required under the Smith Agreement.

CHAPTER 9

OTHER ACTIVITIES TOWARDS IMPLEMENTATION

Forecasts by the Office for Budget Responsibility

57. The OBR has continued to publish forecasts of Scottish taxes twice a year, and the forecast at the Autumn Statement 2014 reflected the Scottish Government's new devolved taxes for the first time (rather than Scotland's share of the corresponding UK taxes).

Cash reserve

58. The cash reserve provides the Scottish Government with a further tool, alongside current borrowing, to help manage the new tax powers.

59. From 2015-16, the Scottish Government will be able to maintain a reserve using an element of tax revenues, which can be accessed if future tax revenues are lower than forecast.

60. In order to support the transition to the new system, Scottish Ministers can currently make discretionary payments into the cash reserve until June 2016 up to an overall total of £125 million. No such payments have yet been made.

Budgeting arrangements for devolved powers

61. Budgeting arrangements have been agreed to support the Scottish Government's spending funded by devolved tax revenues and borrowing.

62. These are based on arrangements already in place in relation to the Northern Ireland Executive's spending that is funded by local tax revenues (council tax and business rates) and borrowing[9] .

[9] The Northern Ireland Executive is responsible for many of the functions performed by local authorities in the rest of the UK. This includes the collection of council tax and business rates and the corresponding borrowing powers.

CHAPTER 10

OTHER REPORTING REQUIREMENTS

63. In addition to the areas covered above (steps taken towards implementation, steps yet to be taken and effect of provisions on the block grant), section 33 of the Scotland Act 2012 requires annual reports on Part 3 of the Act to include:
    - an assessment of the operation of the provisions of Part 3 which have been commenced;
    - an assessment of the operation of any other powers to devolve taxes to the Scottish Parliament or to change the powers of the Scottish Ministers to borrow money, and of any other changes affecting the provisions inserted or amended by this Part;
    - any other matters concerning the sources of revenue for the Scottish Administration (within the meaning of section 126(6) of the 1998 Act) which the maker of the report considers should be brought to the attention of the Parliament of the United Kingdom or the Scottish Parliament.

64. This report is the third following the passage of the Act in May 2012. It should be noted that, in accordance with section 44(2)(b) of the Act, all provisions of Part 3 came into force two months after the passing of the Act itself, with the exception of section 25(7) (and Schedule 2) - Scottish rate of Income Tax: consequential amendments - and section 32 - borrowing by Scottish Ministers. As detailed in paragraph 51 above, section 32 came into force on 12 December 2014. The other provisions will require Orders from HM Treasury before they can be considered operational. An assessment of the operation of the provisions will therefore follow in further annual reports.

65. As outlined in paragraphs 37 and 45 above, the UK Government made provision to disapply SDLT and Landfill Tax in Scotland from 1 April 2015. As these tax powers have not yet been devolved, the Government is unable to provide an assessment of the operation of the provisions.

66. At this stage, no other powers to devolve taxes to the Scottish Parliament have been put into operation and the UK Government is not aware of any other matters concerning the sources of revenue for the Scottish Administration.

CONCLUSION

67. Section 33 of the Scotland Act 2012 stipulates that the Annual Report on the implementation and operation of Part 3 of that Act should be laid on or before the anniversary of the date on which Royal Assent was received, which is 1 May. Due to the Dissolution of Parliament in advance of the May 2015 General Election, this year's report was laid before Parliament in March.

68. The past year has seen us move closer to the full implementation of the Act. Section 32 of the Scotland Act 2012 was commenced[10] in December 2014. The introduction of the Scottish taxes to replace SDLT and Landfill Tax from 1 April 2015 will see more financial accountability and flexibility for the Scottish Parliament.

69. The next annual report on the implementation of Part 3 of the Scotland Act 2012 will be published, in accordance with Section 33(3)(b)of the Scotland Act 2012, before 1 May 2016.

[10] The Scotland Act 2012 (Commencement No. 4) Order 2014

Annex A – Reporting requirements in the Scotland Act 2012 and where they are addressed in this report

1. *a statement of the steps which have been taken, whether by the maker of the report or by others, since the making of the previous report (or, in the case of the first report, since the passing of this Act) towards the commencement of the provisions of this Part,*

    Chapter 2: Paragraphs 7 - 13
    Chapter 3: Paragraphs 16 - 32
    Chapter 4: Paragraphs 37 - 43
    Chapter 5: Paragraphs 45 - 48
    Chapter 6: Paragraphs 50 - 51
    Chapter 7: Paragraph 52
    Chapter 9: Paragraphs 57 - 62

2. *a statement of the steps which the maker of the report proposes should be taken, whether by the maker of the report or by others, towards the commencement of the provisions of this Part,*

    Chapter 2: Paragraphs 14 - 15
    Chapter 3: Paragraphs 33 - 36
    Chapter 4: Paragraph 44
    Chapter 5: Paragraph 49

3. *an assessment of the operation of the provisions of this Part which have been commenced,*

    See chapter 10

4. *an assessment of the operation of any other powers to devolve taxes to the Scottish Parliament or to change the powers of the Scottish Ministers to borrow money, and of any other changes affecting the provisions inserted or amended by this Part,*

   See chapter 10.

5. *the effect of this Part on the amount of any payments made by the Secretary of State under section 64(2) of the 1998 Act (payments into the Scottish Consolidated Fund),*

   See chapter 8.

6. *any other matters concerning the sources of revenue for the Scottish Administration (within the meaning of section 126(6) of the 1998 Act) which the maker of the report considers should be brought to the attention of the Parliament of the United Kingdom or the Scottish Parliament.*

   See chapter 10.

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