Finance and Public Administration Committee

29th Meeting 2023, (Session 6), Tuesday 14 November 2023

Scottish Fiscal Framework: Value Added Tax (VAT) assignment in Scotland

Purpose

1. At its meeting on 26 September 2023, the Committee agreed to hold a roundtable discussion on VAT assignment in Scotland. The updated Fiscal Framework (Fiscal Framework 2023) explains that consideration of when and how to implement VAT Assignment will be picked up at a future meeting of the HM Treasury/Scottish Government Joint Exchequer Committee (JEC).

2. In order to understand the range of challenges that require to be resolved for VAT assignment to commence, the Committee agreed to take evidence in roundtable format from:

   - Charlotte Barbour, Deputy President, Chartered Institute of Taxation,
   - David Phillips, Associate Director, Institute for Fiscal Studies,
   - John Ireland, Chief Executive, Scottish Fiscal Commission
   - Professor Mairi Spowage, Director, Fraser of Allander Institute, and
   - Mark Taylor, Audit Director, Audit Scotland.

3. Submissions from witnesses are each attached at Annexe A.

Background

4. The Scotland Act 2016 provided for the first 10 pence of the Standard Rate of Value Added Tax (VAT) and the first 2.5 pence of the Reduced Rate, to be assigned to the Scottish Government. This gave effect to a recommendation made by the Smith Commission.

5. The Fiscal Framework published in 2016 set out that VAT will be implemented in 2019-2020. There was to be a one-year transitional period during which VAT assignment would be forecast and calculated, but with no impact on the Scottish Budget. From 2020-21 the Scottish Government's budget would then, in part, be determined by forecast and final estimated VAT receipts in Scotland.

6. The assignment of VAT was to be based on a methodology developed jointly by the Scottish Government, HM Treasury and HMRC – the Scottish VAT assignment model - which was published in November 2021. This model is

based on HMRC's VAT Total Theoretical Liability (VTTL) model, which is "an internationally recognised method for calculating the theoretical amount of VAT that should be received by a tax jurisdiction".

7. To allow the development and testing of the methodology for calculating Scotland's aggregated share of VAT liabilities, the Fiscal Framework 2016 explained that there would be a transitional operational period during which VAT assignment will be forecast and calculated each year, but with no impact for the Scottish Government. The effectiveness of the methodology will be reviewed in the final year of the transition period.

8. The Scottish Fiscal Commission (SFC) set out its approach to forecasting VAT in September 2018 and it has subsequently published illustrative forecasts of VAT as supplementary figures to its biannual publication of Scotland's economic and fiscal forecasts. The latest such publication was in May 2023. HMRC, with support from the Scottish Government, also produces experimental statistics which present an estimate of VAT assignment in Scotland. The latest release of these statistics published in September 2023 contains a first estimate for the Scottish VAT share of UK VAT for 2021 and a revised back series to 2011.

9. A briefing note on VAT assignment in Scotland and the experimental statistics has been produced by SPICe and is contained in Annexe B.

10. VAT assignment has yet to be commenced. On 31 October 2019 the then Chief Secretary to the Treasury (CST), the Rt Hon Rishi Sunak, wrote to the Scottish Government to confirm that the transition period for commencing VAT assignment in Scotland would be delayed until April 2021. This was in response to concerns expressed by the Scottish Government[1] about the level of significant volatility under the proposed assignment approach and the lack of verifiable outturn data. In his response, the CST explains that the time afforded by this delay will enable officials to develop and test solutions to mitigate the potential uncertainty in the underlying survey data used to assess VAT receipts.

11. On 12 February 2021, the Session 5 Finance and Constitution Committee published the report of the Legacy Expert Panel which confirmed that—

"The Scottish Government and HM Treasury have, however, agreed to delay implementation due to the current economic uncertainty and the desire not to introduce new volatility to the Budget at this time. Furthermore, the proposed assignment methodology has yet to be agreed. VAT assignment will form part of the planned review of the Fiscal Framework."

12. Subsequently, the Fiscal Framework 2023 states that once the assignment methodology and operating arrangements for assigning VAT in Scotland have been developed and agreed by HMRC and Scottish Government officials, they will be presented for joint ministerial sign-off at a future meeting of the JEC.

[1] Letter from the then Cabinet Secretary for Finance, Economy and Fair Work, Derek Mackay MSP, to the former Chief Secretary to the Treasury, Rt Hon Liz Truss MP, 15 May 2019

Previous Committee scrutiny

13. In March 2019, the Finance and Constitution Committee held a roundtable to explore the methodology to be used for VAT assignment, given the impact that VAT assignment will have on the Scottish Budget. That roundtable explored three aspects of VAT assignment – a summary of which has been set out below.

The purpose of VAT assignment

14. Pillar 3 of the Smith Commission report concerned with Scotland's fiscal framework, including the tax raising and borrowing powers of the Scottish Parliament. The Smith Commission stated that these powers are intended to strengthen the financial responsibility and accountability of the Scottish Parliament and that "the revised funding framework should result in the devolved Scottish budget benefiting in full from policy decisions by the Scottish Government that increase revenues or reduce expenditure, and the devolved Scottish budget bearing the full costs of policy decisions that reduce revenues or increase expenditure."

15. The Session 5 Finance and Constitution Committee's Adviser, David Eiser, confirmed in his March 2019 briefing that the Scottish Government has no power to vary VAT rates or exemptions. The Scottish Budget will be influenced by the growth rates of the assigned VAT revenues relative to the equivalent rest of the UK rates (rUK). At that Committee's meeting in March 2019, Professor Graeme Roy explained that the principle behind the assignment of VAT is the correlation with the strength of the economy such that if the economy does well, "you benefit; if it does worse you are accountable for that." However, as the Scottish Government cannot change VAT rates or the VAT model, this raised questions about what levers the Scottish Government has to control the economy and to control the changes in VAT revenues. It was suggested that consumption might be the lever, but Professor Roy asked whether a Government would wish to "encourage people to spend more and save less".

16. In considering the Smith Commission objective to build in accountability for the performance of the Scottish economy, Professor Roy considered that there was a question over whether, even if the Scottish economy was changing relative to the rest of the UK, that would be reflected in the VAT revenues that were received in Scotland. He argued that there are "fundamental questions about whether the link on accountability is achievable with the assignation of VAT given the complexities of the process."

17. Dr Mathews from the Office of Budget Responsibility (OBR) explained that its VAT forecasts for the UK in the period to 2019 were quite stable given there were relatively few policy changes. As such, "if there was desire to boost consumption in the short term and VAT was used as a policy lever, things could move quite dramatically".

18. Charlotte Barbour from the Institute of Chartered Accountants in Scotland (ICAS) cautioned about the policy consequences that could flow from VAT assignment – for example, would the Government look to support industries that result in increases in VAT revenues rather than, for example, the food industry which tends to be zero rated for VAT? She was also not sure that the correlation between individual policies and VAT assignment is that strong.

19. John Cullinane from the Chartered Institute of Taxation (CIOT) highlighted distributional issues and the connection between VAT assignment and the progressivity of the income tax system – "the belief is that, if incomes are spread more evenly, there will be more consumption" but that might be of products which are zero rated for VAT. He added that he hadn't seen a lot of analysis about how those policies might fit together. Professor Roy also questioned whether it would be possible to trace how any changes in Scottish Government policy would impact on VAT.

20. Alternative models for assigning VAT which might be based on actual VAT outturn data were discussed. John Cullinane explained that that would require designing a set of rules to determine what Scottish receipts are and then ensuring business follows them. John Cullinane and Charlotte Barbour considered that an outturn-based approach would be burdensome and would not address the issues with the VAT assignment model proposed. As Charlotte Barbour observed the "whole point of VAT is that it is designed for a single big market, because it goes in and out with production, adding value as it goes along."

21. Charlotte Barbour also highlighted the challenges in identifying what is Scottish VAT when Scottish-based business may trade outwith Scotland and consumers purchase online.

The VAT assignment methodology

22. As the SPICe briefing note explains, the model proposed for VAT assignment in Scotland uses both estimates to inform the forecasts of VAT followed by use of a VAT Total Theoretical Liability (VTTL) model to provide estimates for subsequent reconciliation. VTTL itself is calculated using a range of data from multiple, mostly publicly available, sources of information.

23. As John Cullinane explained, in terms of having to use estimates for VAT assignment, "it does not matter so much if the estimates are inaccurate on Day 1 as long as they constantly remain inaccurate in the same way". This is because in that scenario the same amount is taken away through the Block Grant adjustment. However, as Mark Taylor from Audit Scotland highlighted, the challenge is in knowing whether it is consistently wrong.

24. There were calls for greater transparency over the details of the assignment model. At the time of the roundtable in 2019, the size of reconciliations that would arise from income tax, devolved taxes and social security was not known. At that time, the VAT model was conceptual but as Mark Taylor from

Audit Scotland explained there was "no detail behind it." He added that there also need to be greater transparency "on the interpretation and assessment of things such as the extent of risk" as well as how that risk is aggregated up.

25. Professor Graeme Roy observed that more detail was needed on the numbers used in the methodology and assessments of sensitivity (such as with sample size) as to how those numbers will change. As an example, he highlighted how 70% of VAT under the assignment model involved looking at consumer spending relying on one survey – the living costs and food survey. By boosting the numbers in this survey, the impact on the GERS numbers in 2016-17 was to take £300 million out of Scottish VAT. This, he explained, "had nothing to do with performance, it was just because the Scottish Government had increased the sample size of the survey".

26. Dr Mathews added that it was also important to establish how important the outliers in the sample and how they feed through the Scottish VAT. He questioned "in future years, if the sample changes and more of these outlier households come in, how much effect will that have?"

27. In his briefing paper the Session 5 Committee adviser, David Eiser highlighted some of the challenges with the robustness of the publicly available survey data being used for estimation:

   - What the sample size will be following any boosts to surveys and any assessments of the adequacy of sample size;
   - The robustness of the other data sources used, such as the various Tourism and visitor surveys;
   - Why some approaches have been used over others (such calculating the Scottish share of central government expenditure using labour market data rather than drawing on public spending data);
   - The partial information given on what some data sources are, such as references to 'construction industry data from ONS' or 'HMRC internal data.' This, he observes, is particularly marked in relation to VAT exempt businesses where 'HMRC confidential data' and 'immediate consumption figures' are referenced but no further information is given.

28. The volatility and uncertainty of the estimation process and the lack of actual outturn figures was discussed. John Ireland from the SFC explained the challenges for the SFC of forecasting on the basis of estimates. He said "the job of the Commission will be not just to estimate the underlying trend but to forecast the random error in the assignment model, which is very hard". Forecasting that random error on a year-by-year basis will be difficult.

29. In addition, as Dr Mathews explained in relation to the forecasts from estimates, the OBR could forecast in a different way than the SFC. There was added complexity in that, if the UK budget had a policy event, "the next forecast would require the Fiscal Commission to react and feed through what that would mean for the Scottish assignment". As a result, the SFC forecast could reflect a different time and context with a resulting impact on reconciliation.

30. Under the Fiscal Framework the block grant baseline adjustment for VAT assignment will be equal to the UK Government's receipts generated from Scotland in the year immediately prior to the devolution of powers. The extent to which that year represented a ‘usual’ year was discussed. Professor Roy highlighted that it would be helpful to see how sensitive the estimates are when a one, two, or three-year transition period is used.

31. Dr Mathews highlighted the ‘VAT gap’ at the UK level– that is the difference between the VAT theoretical liability and actual receipts – was quite large at 8% (in 2019). The causes of the VAT gap were not clear but could include avoidance or evasion; or aspects not captured by the model such as businesses under the VAT threshold. The VAT gap was not, he contended, an issue if it is constant across the forecast albeit he acknowledged that in relation to the Scottish VAT assignment the VAT gap would never been known since actual VAT receipts will not be known.

32. Professor Roy queried whether the pace of change in statistics and data available in the UK can ‘cope’ with what is happening in the context of the wider fiscal framework. He highlighted Canada where there are national economic accounts which are also produced at a state or province level with much more accurate information (albeit a portion of that is based on data from provincial level taxes). He observed, however, that the focus in Canada is more about apportioning national revenues across the provinces than accountability for economic performance.

Risks to the Scottish Budget

33. As Professor Roy explained, there is much more complexity in the VAT system than the income tax system. How all the risks associated with devolved taxes, income tax and VAT assignation interact is a key challenge. The volatility in both the estimates of the BGA and the tax take could cancel each other or build on each other. Mark Taylor from Audit Scotland highlighted two key aspects to managing the risks of VAT assignment within the Scottish Budget:

- What is the Scottish Government policy on reserves and borrowing? And how does it set up that policy so that it copes with future uncertainty?
- In relation to adjustments, how do spending plans cope with the inevitable year to year volatility - “to what extent does everything get based lined meaning that you are storing up problems for the future”.

34. He added that key is knowing what permanent and recurring effects are due to economic performance and what are due to volatility and error within the assignment model. In addition to which is the question about the extent to which Audit Scotland and the National Audit Office are able to design an approach that provides assurance over how the methodology is working in practice given the calculations are based on a variety of sometimes confidential survey data. Dr Matthew provided the example that, if outturn data changed

dramatically and the reason why lay within confidential data, it would be challenging for the forecasters, and also others, to explain.

35. John Ireland explained that if the OBR forecast error for VAT of 2.4% was applied to Scottish VAT then the error would be between £100 million - £200 million (in 2019). Reconciliation then depends upon the combination of the forecast error for Scottish VAT and rUK VAT. Dr Mathews added that understanding behavioural response to policy changes is hard to understand, which adds another potential source of variance. He said “there is the economy variance plus the methodology error in relation to the survey, and then there is the policy costing error on top of that, so we could have wide confidence intervals”.

36. Responding to whether the using of a multi-year average (say over three years) for surveys would reduce the methodology error, Professor Roy considered it could. He added, however, that using multi-year averages would break the link between accountability, policy changes and actual outcomes since it will smooth the numbers over time.

Other factors

37. Following the evidence session in March 2019, the Finance and Constitution Committee wrote to the then Cabinet Secretary for Finance, Economy and Fair Work recommending that the VAT assignment methodology should continue to be reviewed. That Committee highlighted the evidence it heard of the increased risk to the Scottish Budget due to the statistical uncertainty inherent in the method proposed and in the data sources used.

38. In his letter to the then Chief Secretary to the Treasury on 15 May 2019, the then Cabinet Secretary considered that the “lack of the verifiable outturn data available for all other devolved taxes, is not an appropriate basis for assigning annual revenues of almost £6 billion.” He also highlighted the uncertainty of EU exit, adding that Scotland does not have the full levers necessary to combat such volatility. He therefore also called VAT assignment to be delayed and considered as part of the Fiscal Framework review.

39. Since VAT assignment in Scotland was considered by the Session 5 Finance and Constitution Committee in March 2019:

- Devolved taxes, Scottish income tax and social security benefits have been operational for a number of years;
- the UK has exited the European Union with the subsequent EU-UK Trade and Cooperation Agreement and the Windsor Framework approved;
- the COVID-19 pandemic, inflation and a cost-of-living crisis have all had a significant impact on Scotland’s finances and economy;
- a revised Fiscal Framework has been agreed by the UK and Scottish Government’s in 2023;
- falling response rates to some surveys has been observed;

- the implications for the Scottish Budget of the demographic challenge Scotland faces, of an ageing as well as a declining population, has become more prominent.

40. **The Committee is invited to discuss with witnesses the issues in this paper and in the submissions received.**

Committee Clerking Team
November 2023

ANNEXE A

Written Submission from Chartered Institute of Taxation

VAT Assignment

Roundtable session with the Scottish Parliament's Finance and Public Administration Committee

Response by the Chartered Institute of Taxation

1 Executive Summary

1.1 The assignment of a proportion of UK VAT revenues raised in Scotland to the Scottish budget was recommended by the Smith Commission and legislated for in the Scotland Act 2016. Despite this, a number of concerns have been raised about how VAT assignment will work in practice. Many of these issues, first considered by the committee's predecessor, the Finance and Constitution Committee, persist. These include: the lack of a suitable model for identifying and assigning VAT revenues raised in Scotland, the lack of policy autonomy that would be afforded to the Scottish Government from a policy of 'assignment', and the introduction of additional risks to the Scottish budget.

1.2 'Assignment' means apportioning some of the UK VAT revenues to the Scottish budget – it is an allocation model. By contrast, 'devolution' means responsibility for the tax being given to the Scottish Parliament, such as with the full devolution of taxes on land transactions or partial devolution of the rates of tax (as with Scottish income tax).

1.3 The idea of VAT devolution is theoretically possible but would not be straightforward, adding complexities for businesses to comply with their tax obligations. It could introduce opportunities for distortive behaviours such as tax avoidance.

1.4 Our view to date has been that it is not practical or desirable for businesses to keep separate records of VAT receipts raised in Scotland, which would be necessary for a devolved VAT.

2 About us

2.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 19,000 members, and extensive volunteer network, in providing our evidence.

2.2 The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

2.3 The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties, UK and devolved taxes. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

2.4 The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.

2.5 Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

2.6 Our stated objectives for the tax system include:

- A legislative process that translates policy intentions into statute accurately and effectively, without unintended consequences.
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
- Greater certainty, so businesses and individuals can plan ahead with confidence.
- A fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented).
- Responsive and competent tax administration, with a minimum of bureaucracy.

3 Introduction

3.1 In August 2023, The Scottish and UK governments agreed an updated Fiscal Framework[2]. In relation to VAT, the Framework notes that: “It was agreed in the 2016 Fiscal Framework agreement that the full details of the VAT assignment methodology will be jointly developed and agreed by both HMRC and Scottish Government officials. Once completed and agreed by officials, the assignment methodology and operating arrangements will be presented for joint ministerial sign-off at a future meeting of the Joint Exchequer Committee.”

3.2 The Finance and Public Administration Committee has agreed to hold a one-off roundtable evidence session on VAT assignment in Scotland. The Committee is keen to explore whether the previous issues with assigning VAT persist (as highlighted by the previous Committee in 2019[3]). The Committee also wishes to discuss whether any new issues and/or solutions have arisen since then and what issues require to be resolved in order for VAT assignment to be implemented.

3.3 The following questions have been posed:

1. Do the previous issues with assigning VAT persist?
2. Have any new issues/solutions arisen since 2019 (when the Finance & Constitution Committee (F&CC) last considered this topic)?
3. What issues require to be resolved in order for VAT assignment to commence?

4 VAT Assignment – Background

4.1 The Smith Commission[4] report, paragraph 84, noted that *‘The receipts raised in Scotland by the first 10 percentage points of the standard rate of Value Added Tax (VAT) will be assigned to the Scottish Government’s budget. These receipts should be calculated on a verified basis, to be agreed between the UK and Scottish Governments, with a corresponding adjustment to the block grant received.’*

4.2 This has been given legislative effect in section 16 of the Scotland Act 2016[5]. Under the proposals the first 10 percentage points of the Standard rate of VAT raised in Scotland, and the first 2.5 percentage points of the reduced rate of VAT, in other words half the amount of VAT raised in Scotland, would be directly assigned to the Scottish budget.

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[2] https://www.gov.scot/publications/fiscal-framework-agreement-between-scottish-uk-governments/
[3] https://archive2021.parliament.scot/parliamentarybusiness/CurrentCommittees/111059.aspx
[4] https://webarchive.nationalarchives.gov.uk/ukgwa/20151202171017/https:/www.smith-commission.scot/
[5] https://www.legislation.gov.uk/ukpga/2016/11/section/16/enacted

4.3 VAT is the only 'assigned' tax in the package of taxes that fund Scotland. The intention with VAT assignment is that it should be possible to allocate an amount of revenue directly to the Scottish budget without creating additional administrative burdens for traders or the tax authorities.

4.4 It should be noted that the Fiscal Framework is an agreement between the Scottish and UK governments and therefore does not have legal force. The revised Fiscal Framework[6] agreed in August 2023 sets out that the VAT assignment methodology is to be jointly developed and agreed by both HMRC and Scottish Government officials and then presented for joint ministerial sign-off at a future meeting of the Joint Exchequer Committee, the date yet to be confirmed.

4.5 The assignment model[7] discussed to date is based on the VAT Total Theoretical Liability model (VTTL Model).

4.6 In effect, VAT assignment is a sharing of locally generated taxes. The tax remains a UK-wide tax, with the UK Government retaining full legislative and administrative responsibility, albeit with a proportion of the revenues raised in Scotland directly allocated to its budget. It is a funding mechanism, rather than a tax power, that is designed to introduce an element of fiscal responsibility, by linking the budget more closely to the performance of the Scottish economy. Although it may represent a significant revenue raiser, the Scottish Government will have no direct tax levers to exercise in relation to its amount.

4.7 The estimated Scottish VAT Assignment share of UK VAT ranges from 4.24% to 4.57% from 2011 to 2021, with the exception of 2020 where VAT Assignment share fell to 4.03% due to COVID-19 impacts. This equates to £ 5,933 million in calendar year 2021. See 'Scottish VAT assignment 2021 – experimental statistics'[8], published on 28 September 2023 (and which has further analysis and stats).

4.8 Our view to date has been that it is not practical or desirable for businesses to keep separate records of VAT receipts raised in Scotland. It may also not even be feasible to arrive at a figure for the amount of VAT raised in Scotland

[6] https://www.gov.scot/binaries/content/documents/govscot/publications/agreement/2023/08/fiscal-framework-agreement-between-scottish-uk-governments/documents/2023the-agreement-between-scottish-government-united-kingdom-government-scottish-governments-fiscal-framework/2023the-agreement-between-scottish-government-united-kingdom-government-scottish-governments-fiscal-framework/govscot%3Adocument/2023the-agreement-between-scottish-government-united-kingdom-government-scottish-governments-fiscal-framework.pdf

[7] https://assets.publishing.service.gov.uk/media/5bf69c1eed915d184076bf68/VAT_assignment_model_publication_final_1.pdf

[8] https://www.gov.uk/government/statistics/scottish-vat-assignment-experimental-statistics/scottish-vat-assignment-experimental-statistics-2020

because HMRC does not hold the data. Assignment is the lesser of two evils because it does not call upon businesses to administer 'Scottish' VAT.

5 Question 1: Do the previous issues with assigning VAT persist?

5.1 Overall, we consider that the issues previously identified when VAT assignment was last examined by the Finance and Constitution Committee remain. They include the following issues:

5.2 The aim of VAT assignment is to bring greater accountability to decision making in Scotland. However, the Scottish Government will have no direct controls over VAT rates and policy. At best, the government may seek to grow the economy in order to increase the VAT tax take, but it will be difficult to connect Scottish economic decisions to the tax, and to show a clear line of accountability between the Scottish Government and the operation of the tax.

5.3 VAT policy making will remain a UK Government responsibility and so there may be questions over whether, and to what extent, the Scottish Government is able to input to the policy making process. As a result, there may be a lack of control or ability to influence VAT policy and the way in which it may affect wider economic policy.

5.4 There has been much debate about a lack of public awareness and understanding of the different tax responsibilities at different levels of government (UK, Scottish, and local). In a poll on awareness and understanding of the devolved taxes, conducted for CIOT by Diffley Partnership in January 2023, 12% of Scots surveyed said they thought powers over VAT were the responsibility of the Scottish Parliament (compared with 73% who correctly identified that it was a decision for the UK Parliament). While this 12% figure is relatively low, this is the highest number CIOT has recorded since it first polled this question in 2018. This lack of understanding will not be assisted if there is also VAT Assignment added into the mix. See 'Poll suggests growing confusion over Scottish taxes'[9] (CIOT news release, 9 February 2023).

6 Question 2: Have any new issues/solutions arisen since 2019 (when the F&CC considered this)?

Post Brexit

6.1 Now that the UK has left the European Union, it is no longer subject to EU VAT law, opening up the potential for change. Although VAT law in the UK is still based on EU

[9] https://www.tax.org.uk/poll-suggests-growing-confusion-over-scottish-taxes

requirements, over time there is no barrier to VAT law being modified or more radically reformed. Change could happen across the single UK market, or it could potentially involve some devolution of VAT powers to the nations and regions of the UK.

6.2 The Scottish Government has previously called for the devolution of VAT powers to the Scottish Parliament. We think more analysis and understanding of the impacts and options is required before advocating the devolution of either, or both, VAT rates or policy. VAT is not designed for ease of use over borders as it is designed to operate in a single market without variation in rates (i.e. one Standard Rate (SR), one Reduced Rate (RR), and Zero Rate (ZR)), thresholds or exempt transactions).

6.3 Also, variations in taxes (rates, incidence, thresholds) can lend themselves to tax planning. VAT is a very expensive tax for taxpayers and businesses because it is based on turnover on all taxable sales at 20% (accepting that some items may have a reduced or zero rate applied to them). There is a great deal at stake, either in pricing (the cases of, say, Jaffa cakes, tea cakes or Pringles illustrate the competitive issues of whether an item is standard or zero rated), or fraud. For example, the basic Missing Trader Intra Community (MTIC) fraud model involves organised, sophisticated activities that seek to exploit cross-border differences in how VAT is treated in different EU Member States and could also apply within domestic borders if the rates varied.

Making Tax Digital (MTD) for VAT

6.4 Making Tax Digital, MTD, is part of HMRC's tax administration programme with a focus on the digitalisation of the tax system. MTD for VAT has been implemented in stages since April 2019 and is a reporting mechanism whereby traders record their transactions – and the associated VAT – online, and then submit their tax returns online to HMRC. The aim is to lessen the scope for mistakes.

6.5 However, MTD for VAT has simply taken existing processes online and does not assist in identifying the jurisdiction of any transaction so in its current form would not assist HMRC in analysing receipts received in Scotland.

6.6 Although digital systems could assist in years to come, this is a long way off in terms of system design. 'Digital' is not an immediate solution to providing a mechanism for identifying Scottish VAT.

Ongoing analysis and modelling

6.7 As part of the UK official statistics, VAT assignment has been forecast and calculated each year, but with no direct impact on the Scottish Government's budget. The aim of these forecasts has been to allow for the development and testing of the methodology for calculating Scotland's aggregated share of VAT liabilities. See 'Scottish VAT assignment 2021 – experimental statistics'[10], published on 28 September 2023.

[10] https://www.gov.uk/government/statistics/scottish-vat-assignment-experimental-statistics/scottish-vat-assignment-experimental-statistics-2020

6.8 This work shows that the assignment based on the VTTL model can be done, but it does not address the underlying concerns that were expressed in 2019 and that remain today.

6.9 The revised Fiscal Framework[11] notes that: ‘The methodology for apportioning VAT revenues to Scotland will be used to estimate receipts in the year immediately prior to assignment. This will be reconciled to outturn using the same methodology once the relevant data is available’. However – there is no true outturn – it can only ever be compared with a rerun of the model.

6.10 The following caveat has been included alongside the recently published statistics: ‘It is not possible to directly measure VAT raised in Scotland as the information collected from businesses through VAT returns does not specify the UK region of consumption. The share has been estimated using the Scottish VA model, jointly developed by officials from UK government and Scottish Government.’ This therefore suggests that a degree of uncertainty remains in the ability to accurately identify VAT receipts raised directly in Scotland using the jointly developed assignment methodology.

Reports on devolved taxes

6.11 A number of studies have been undertaken across the United Kingdom relating to devolved taxes, which include consideration of the issue of VAT devolution and assignment.

6.12 The final report of the Independent Fiscal Commission for Northern Ireland, *More fiscal devolution for Northern Ireland?*[12], issued in May 2022, said: ‘We also do not consider pure tax assignment as a desirable way forward. That brings risks without the policy levers gained from additional powers. Tax assignment occurs when the devolved government’s budget depends on the revenues raised from within its territory, but the devolved government has no ability to vary tax policy (which is set by the central government). In principle this could create the right incentives to improve economic policy so as to increase incomes and hence revenues. In practice, economic performance, and hence tax receipts, will vary for many reasons outside of the control of the devolved administration.’

6.13 It concluded that ‘There is a case, in principle, for devolution of VAT to Northern Ireland. However, the uncertainty regarding the significant additional compliance and administration burdens relative to income tax are sufficient that, in our view, further work at this stage should prioritise consideration of options for devolving income tax, rather than VAT. At this stage, therefore, we will not be carrying this tax forward for consideration as part of the second phase of our work.’

[11] https://www.gov.scot/binaries/content/documents/govscot/publications/agreement/2023/08/fiscal-framework-agreement-between-scottish-uk-governments/documents/2023the-agreement-between-scottish-government-united-kingdom-government-scottish-governments-fiscal-framework/2023the-agreement-between-scottish-government-united-kingdom-government-scottish-governments-fiscal-framework/govscot%3Adocument/2023the-agreement-between-scottish-government-united-kingdom-government-scottish-governments-fiscal-framework.pdf
[12] https://www.fiscalcommissionni.org/files/fiscalcommissionni/documents/2022-05/web-version-executive-summary-may-2022-accessible.pdf

6.14 The Poverty and Inequality Commission[13] set up to advise the Scottish Government on its anti-poverty agenda has also examined how tax policy can be used in Scotland to support this agenda. The report of its Tax Working Group said: ‘While the assignment of VAT to Scotland has been a long-standing topic of discussion between the Scottish and UK governments, there appears to the Commission to be little prospect of a viable methodology to allow this to be further developed, and the Commission believes the Scottish Government should focus its efforts on other areas.

7 Question 3: What issues require to be resolved in order for VAT assignment to commence?

A preliminary point

7.1 As previously noted in this paper, it is businesses who are the collectors of VAT. They are unlikely to welcome any further administrative burdens that further complicate their ability to comply with their tax obligations, such as having to identify ‘Scottish VAT’.

7.2 If half the receipts of VAT received in Scotland are to be allocated to the Scottish budget, then assignment needs to be based on some form of allocation model, which, as set out above, is not an easily resolvable requirement.

The principles of VAT Assignment need to be met

7.3 The principles of VAT Assignment should be robust and properly represent ‘Scottish VAT’. Further discussions around the prospects for VAT assignment must include consideration of:

- **Transparency** - will it be clear to those with an interest in the policy (such as the Scottish and UK governments, politicians, taxpayers, and the wider public) about understanding the connections between the amounts allocated under VAT assignment and the performance of the Scottish economy?
- **Accountability** – can the actions of the Scottish Government be clearly linked to the taxes raised?
- **Robust data** - where does the data come from? Is it reliable? And is it robust? It should also be noted that businesses do not want additional burdens so robust data has to come from government sources and should not impose any further requirements on business.

[13] https://povertyinequality.scot/wp-content/uploads/2023/10/How_better_tax_policy_can_reduce_poverty_and_inequality_October2023.pdf

Risk

7.4 VAT Assignment will introduce further risk into the Scottish budget. This is the point of tax devolution, alongside increased accountability, but it needs to be risk that is within the Scottish Government’s control i.e., properly tied to the economy in Scotland and to actions that the Scottish Government can take.

7.5 There are a number of risks that we believe may be outside the Scottish Government’s control. The proposed model, based on the VAT total theoretical liability referenced above, is the total value of VAT that could be theoretically collected from the tax base across various sectors. The proposed methodology relies heavily upon survey data, particularly the Living Costs and Food Survey. In 2019, the proposed sample was small, 360 households in Scotland, and it was not known if this was representative across the income spectrum.

7.6 There may be areas where the underlying economy in Scotland differs from the rest of the UK, such as:

- **Household spending models** – for instance, is there a higher proportion of low-income households and hence those who tend to have expenditure predominantly on zero rated items such as food?
- **Impact of tourism/hospitality sector** – and it is notable in the experimental Scottish VAT assignment statistics the level of impact tourism had on VAT receipts during covid.
- **Impact of financial services sector**, which is a significant part of the Scottish economy with many services exempt from VAT.

7.7 There will be no available outturn data as the model is based on theoretical, not actual, data. If the model does not properly reflect ‘Scottish VAT’ there is no means of checking this. With this type of model one cannot produce actual outturn data.

Potential unintended consequences

7.8 There may also be unintended consequences to consider as a result of VAT assignment. For example, the proposed model is tied to spending, rather than the performance of the economy, meaning that VAT calculations will include the impact of imports into the country. Therefore, it may not be a useful indicator in determining the performance of the domestic economy.

7.9 If the VAT assignment model is properly linked to the performance of the Scottish economy, then it could lead to policies designed to favour the generation of VAT receipts. In principle this is understandable, but it might also come at the expense of other areas of the Scottish economy that may not generate significant amounts of VAT. For example, two key sectors to the Scottish economy are tourism and food and drink. The former is a sector that will generate largely standard rated VAT receipts while the latter, although an important driver of the economy, produces products that will be largely zero rated for social policy reasons or due to being exported. Awareness of these behavioural drivers is needed.

The Chartered Institute of Taxation, 9 November 2023

Written Submission from Institute for Fiscal Studies

VAT assignment – key points

David Phillips, Institute for Fiscal Studies

The best overall summary of my views on VAT devolution and assignment can be found in an IFS report that we wrote looking at options for tax devolution to English local government, and the section on VAT assignment and devolution in the NI Fiscal Commission's report (which I very largely wrote). (Adapted) sections of the former are repeated below for ease of reference. Following this I include a couple of additional thoughts on the potential to improve data and the circumstances in which VAT devolution may be worth considering.

IFS Report: Taking Control: which taxes could be devolved to English local government? (March 2019)

The main rationales for devolving part of VAT would be to provide the Scottish Government financial incentives to grow the tax base, and provide more flexibility over the tax rate and potentially structure of the tax base (e.g. exemptions). However, VAT has properties that make it a relatively poor candidate for devolution.

Challenges in devolving VAT

- Apportioning VAT revenues to different local areas is conceptually and administratively difficult. Similar to corporation tax, this partly relates to difficulties in apportioning value added between different stages and activities conducted by a single business, such as warehouse, store, website and support operations.
    - However, it also reflects the way VAT works: it is charged on sales, but businesses can deduct the VAT they have paid on their inputs. Depending on how it is devolved, VAT could mean businesses not only having to charge different VAT rates in different areas, but also having to record where their input purchases came from, as different amounts of VAT would be deductible based on this. This would involve high administration and compliance costs. Alternatively, borders between Scotland and rUK could work like international borders for the purposes of VAT: businesses 'exporting' from one part of the UK to another would charge a 0% rate on their 'exports'. But this would require

businesses to record where their business customers were located and to charge VAT accordingly, which would again be a costly process. It could also be open to the same kinds of abuse seen internationally, although the fact that HMRC would be on both sides of the transaction (it would be the tax authority for both the seller and buyer) should reduce those risks somewhat.

- o Giving the Scottish Government the power to set a local sales tax as opposed to a VAT would avoid these problems. A sales tax differs from a VAT in that the tax is only levied on sales to final consumers or unregistered businesses. Because no tax is charged on sales to registered businesses, there is no need for a system of deduction of sales tax paid on business inputs. This makes devolution easier and, as discussed in Section 2, the United States has a system of sales taxes varying by state, county and city.
- o However, sales taxes come with their own issues. Businesses need to distinguish whether a sale is to a registered business or not, and to charge tax accordingly. In order to reduce prices for final consumers and registered businesses, they have an incentive to misclassify such sales as business sales, which is hard for the tax authorities to check and prevent. Partly as a result, sales taxes are seen as more prone to tax evasion than VATs.[14]

- The VAT base is relatively mobile across areas. Consumers are able to change where they buy goods in services in response to differences in VAT or sales taxes, and this is turn may affect where businesses choose to locate. This is particularly true when people live close to 'borders' between different tax rates, and when the transaction value is high, as the monetary and time costs involved in travelling to the low-tax area are then relatively low. Evidence for such cross-border shopping is found in numerous studies, covering numerous goods including tobacco, alcohol, petrol and food.15 Impacts can also be significant: a study on petrol suggested Chicago's tax base was 40% lower as a result of cross-border purchases from the neighbouring areas of Illinois and Indiana with lower taxes, for instance (Manuszak and Moul, 2009).
  - o The growth of internet shopping is likely to have exacerbated this issue, except in the case where internet retailers are required to charge taxes based on where people live rather than where the retailer or its warehouses were based. Evidence from the United States – where this approach is not allowed, and many online sales have traditionally avoided sales tax altogether – suggest such effects can be big. For example, a 4% cut in New York's sales tax was accompanied by an average 15% fall in internet and catalogue sales as people switched

14 See Zodrow (1999).
15 Leal, Lopez-Laborder and Rodrigo (2010) provide an overview,

back to physical stores (Hu and Tang, 2014). Significant effects of sales taxes on physical and internet sales on Ebay and for cigarettes across the United States have also been found (Einav et al, 2014; Goolsbee, Lovenheim and Slemrod, 2010).
- The evidence therefore suggests that variation in local VAT or sales tax could cause significant distortions to where expenditures take place.
- As with corporation tax, depending on the equalisation rules in place, tax competition between local areas, or the political attractiveness of increasing a tax that may fall to a significant extent on people living elsewhere, could also lead to downward or upward pressure on VAT rates.

The rationales for devolving VAT

One rationale is stronger financial incentives for the Scottish Government to boost economic activity. The nature of these incentives would depend on how it is devolved and accounted for:

- If it were devolved so that the economic border between Scotland and the rest of the UK was treated in the same way as international borders are currently treated, it would provide an incentive to boost final VATable consumption in Scotland. This could be by boosting consumption of existing Scottish residents (and exempt business and government activity), or attracting new residents (or exempt business or government activity) with high VATable expenditures.
- If it were devolved so that sellers charge their country's VAT wherever they sell to in the UK, and buyers reclaim the VAT rate paid on their purchases, the incentive would be to increase the value added in Scotland. This could be by boosting the value-added of existing businesses in Scotland and attracting new businesses to Scotland. These incentives would be broader than for corporation tax as VAT applies to businesses' labour costs as well as profits – thus incentivising the Scottish Government to take action to promote employment and earnings too.

The second broad rationale relates to the powers to vary the level and structure of the tax. Powers to vary the VAT rate and base would also allow councils to use VAT as a policy lever to promote economic development, and better match local preferences over tax levels and mix. The VAT could be increased to raise additional revenue to increase spending or cut other tax rates, or could be reduced if the Scottish Government wanted to shift the tax burden to other tax bases, or were willing to reduce spending. Changes to the tax base (e.g. exemptions, goods and services subject to different tax rates) could be used to support particular sectors or groups of consumers, although VAT policy is often not the best way to either support business or households (for example, exemptions or reduced rates for necessities nearly always benefit richer households more in cash terms and are less effective tools for redistribution than benefits).

What about Assignment?

While preventing tax competition and economic distortion associated with variation in tax rates, assignment of part of VAT revenues would still involve the tricky issue of apportioning revenues between local areas.

However, a number of EU countries, including Italy, Spain and Portugal, assign part of revenues to sub-national government; and in the UK, it has been agreed in principal for half of estimated VAT revenues for Scotland to be assigned to the Scottish Government (in lieu of grant funding from the UK Treasury). This is on hold though: the method proposed to calculate the amount of VAT revenues arising in Scotland would reliy to a large extent on surveys of household spending, for which sample sizes for Scotland are too small to be reliable (HM Treasury, 2018). Estimated tax takes for different Scotland could vary significantly from year to year, based on the particular sample of households in the survey that year, and such statistical ‘noise’ could swamp the ‘signal’ due to genuine changes in business activity and VAT revenue.

Additional comments

VAT assignment

- I do not believe the proposed approach (based on household survey data) is worth pursuing for the reasons outlined above. I think the noise versus signal ratio would adversely affect the financial incentives faced by the Scottish Government, add extra volatility and forecasting difficulty to an already tricky fiscal framework and budget setting process.
- The use of digital financial data – especially from credit and debit card transactions -, combined with a survey of larger businesses on card versus cash transactions, and tax admin data on small businesses reported sales – could allow for significant improvements in data quality accuracy for VAT assignment. The IFS is planning on research using this data to estimate tax bases for local sales taxes in England, subject to funding availability.
- Even with this better data, in contrast to existing devolved or partially devolved taxes, there would be no “outturn” revenues, only “estimates” as opposed to “forecasts”. This could still be seen as unfair as the Scottish

Budget could increase or decrease because of measurement error in that estimate.

VAT devolution

- The administrative difficulties of devolving VAT to Scotland should not be overstated – it would, in effect, create a bit of an economic border for trade between Scotland and the rest of the UK, with additional administration and compliance costs entailed. If rates varied there could also be incentives to engage in cross-border shopping, and potentially for businesses to locate strategically on one side of the border than the other (this is seen frequently in America). The fact that the England/Scotland border is less densely population than the Welsh one means these issues would be less significant for Scotland than Wales. But they would be more significant for Scotland than Northern Ireland, which does not share a land border with rUK but does with the Republic of Ireland, and already has some of the administrative architecture in place given the Northern Ireland protocol.
- In my view it would only be worth these administration and compliance costs and potential economic distortions if the Scottish Government felt that VAT policy was a very important complement to its existing policies for revenue-raising, redistribution, economic development and other policy objectives that it would use to a *significant extent.* This could mean a VAT rate change of more than 1 percentage point, or significant changes in the scope of exemptions or reduced rates. In considering this it should bear in mind that other levers open to it (e.g. existing devolved taxes, social security benefits) may be better targeted at addressing the issues it is considering VAT for.

Written Submission from the Scottish Fiscal Commission

The Scottish Fiscal Commission and VAT Assignment

Introduction and background

The SFC's role if the assignment of VAT were operationalised would be to produce the official forecast of revenue for use in the Scottish Budget. The development of a model to assign UK VAT revenues to Scotland in the absence of outturn data is the joint responsibility of HMRC, HM Treasury and the Scottish Government. Similarly the design of arrangements on the block grant adjustment and how forecast errors are reconciled is the responsibility of HMT Treasury and the Scottish Government.

In our Scotland's Economic and Fiscal Forecasts publication we include an illustrative forecast for VAT assigned to Scotland. As there is no date set for the implementation of VAT assignment we refer to that forecast as illustrative and it does not inform the Scottish Government budget. Our latest forecast from May 2023 is shown in Figure 1.

Figure 1: SFC forecast revenue for Scottish VAT Assignment – Figure S4.27 in Tax Supplementary Tables

(£ m)	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29
	5,348	6,080	6,363	6,520	6,622	6,783	7,024	7,274

Source: Scottish Fiscal Commission (2023). Scotland's Economic and Fiscal Forecasts May 2023 (link)

Our approach to forecasting VAT Assignment

The first step in the production of our illustrative forecast for VAT assignment is to estimate total expenditure in Scotland that would be liable for VAT for each year of the forecast. We do this by taking VAT Assignment figures provided to us by HMRC and growing these using Scottish specific determinants from our economy forecast.

We then make adjustments to the forecast of total expenditure to account for things such as domestic tourism and OBR policy costings. To this adjusted forecast for expenditure liable for VAT we apply the appropriate tax rate, which is 20 per cent for most goods and services and 5 per cent for reduced rate areas such as home energy, to produce a forecast of total VAT receipts in Scotland. In the final step of the forecast we convert this to the value that would be assigned to the Scottish Budget, which is currently 50 per cent of the receipts.

More detailed information on our approach to forecasting Scottish VAT assignment is provided in our 2018 occasional paper.[16]

HMRC Scottish VAT Assignment Statistics

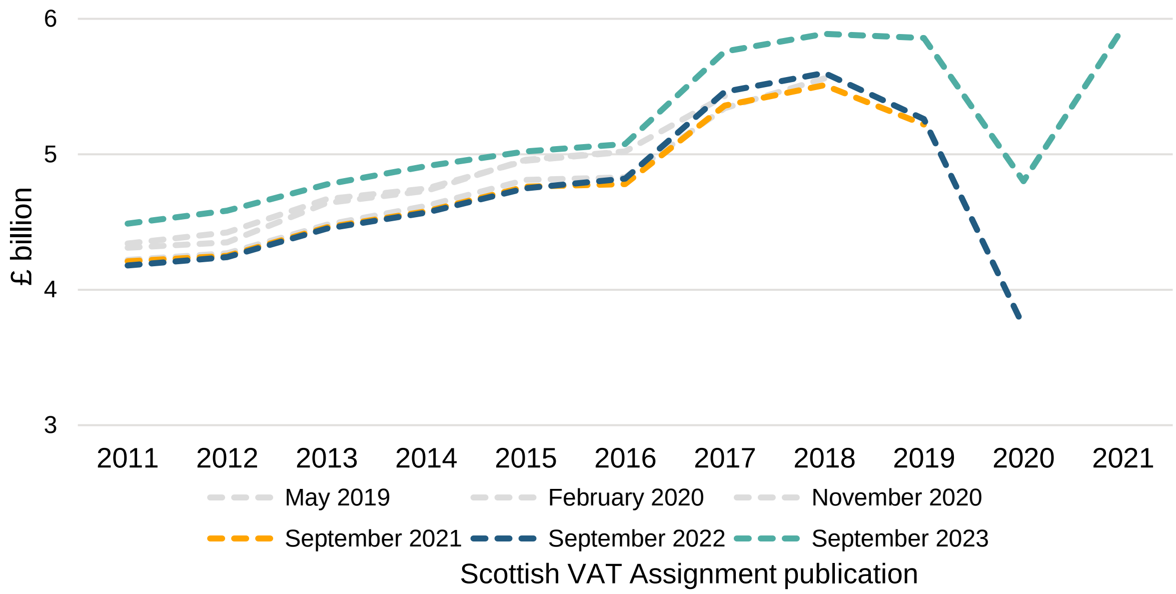
VAT is collected by HMRC at a UK level. VAT returns include no information on where in the UK the sales of goods and services took place. It is therefore not possible to directly apportion VAT by country, and not possible to calculate VAT raised in Scotland from tax returns. Therefore, HMRC produces estimates of Scottish VAT Assignment using a statistical model and publishes outputs each year.

HMRC published the latest release in September 2023 and included the first estimate for 2021. This release has revised estimates going back to 2011, making substantially larger upwards revisions than in previous releases.[17] As our latest illustrative forecasts were published in May 2023 (Figure 1), they did not incorporate the revised estimates from HMRC.

Figure 2 shows that HMRC estimates for Scottish VAT Assignment have been subject to frequent revisions, with those applied in September 2023 particularly large. HMRC provides more information on these revisions in section 2.4 of their supplementary information accompanying the publication.[18]

[16] Scottish Fiscal Commission (2018) – Approach to Forecasting Value Added Tax (link)
[17] HM Revenue and Customs (2023) - Scottish VAT Assignment 2021 (link)
[18] HM Revenue and Customs (2023) - Scottish VAT Assignment – supplementary information (link)

Figure 2: HMRC Estimates of Scottish VAT Assignment , 2011 to 2021



Source: HM Revenue and Customs (2023) Scottish VAT Assignment (link)

Figure 3: HMRC Estimates of Scottish VAT Assignment 2011 to 2021, £ billion

Publication	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
September 2022	4.2	4.2	4.5	4.6	4.8	4.8	5.5	5.6	5.3	3.7	-
September 2023	4.5	4.6	4.8	4.9	5	5.1	5.8	5.9	5.9	4.8	5.9
Difference	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.6	1.1	-

Source: HM Revenue and Customs (2023) Scottish VAT Assignment (link)

These regular revisions to HMRC estimates for Scottish VAT Assignment create a challenge for us in our ability to produce accurate forecasts as we are without a reliable baseline on which to construct our forecasts.

Estimates of forecast error

We can illustrate the potential scale of errors in our forecasts for Scottish VAT Assignment if we followed the same the process we have in place for Scottish income tax. HMRC publishes an outturn Scottish income tax figure around 16 months after the end of the financial year and this figure does not usually change thereafter. For Scottish VAT assignment, HMRC publishes the first estimate around 18 months after the end of the financial year. This means that HMRC estimates for 2021-22 published in September 2023 would allow us to calculate the error in the illustrative forecast we produced in January 2021 alongside our forecasts for the 2021-22 Scottish Government budget.

Figure 4: Illustrative forecast errors of Scottish VAT Assignment

(£ m)	2019-20	2020-21	2021-22
Illustrative Budget setting forecast	5,801	5,727	5,246
Outturn estimate	5,220	3,730	5,933
Illustrative Error	-581	-1,997	687

Source: Scottish Fiscal Commission (2018) Scotland's Economic and Fiscal Forecasts (link), Scottish Fiscal Commission (2020) Scotland's Economic and Fiscal Forecasts (link), Scottish Fiscal Commission (2021) Scotland's Economic and Fiscal Forecasts (link), HM Revenue and Customs (2023) Scottish VAT Assignment (link)

Figure 4 shows the scale of errors in our illustrative forecasts for Scottish VAT assignment using the same budget setting forecast and timing of outturn data as we have in our Forecast Evaluation Reports for Scottish income tax. Note that the coronavirus (COVID-19) pandemic and the associated VAT deferral scheme will be a significant factor in the illustrative error for 2020-21. The outturn estimate for 2020-21 has since increased by around £1.1 billion which would give us a much smaller illustrative forecast error if we used this outturn figure instead.

There are two factors that mean forecasting Scottish VAT Assignment is likely to be more challenging than other devolved taxes. Firstly, with income tax and other devolved taxes we have reliable estimates of how much tax is collected in Scotland, but as equivalent data is not available on VAT raised in Scotland we are reliant on HMRC estimates produced using a statistical model, which is likely to be less correlated with our economic determinants than the true amount. Secondly, we expect revisions to HMRC estimates of Scottish VAT Assignment will continue to occur, although likely not of the same magnitude as in the latest publication, in future years.

In advance of any implementation of Scottish VAT Assignment we will continue to develop our approach with the aim of improving the accuracy of our forecasts. However, challenges such as the revisions to outturn data mean that there will continue to be a risk of errors in our forecasts.

Scottish Fiscal Commission, November 2023

Written Submission from the Fraser of Allander Institute

VAT Assignment: Submission
November 2023

The best summary of our thoughts on VAT assignment are contained in a number of blogs we have written over the years:

- https://fraserofallander.org/vat-assignment-a-bridge-too-far-for-fiscal-devolution/
- https://fraserofallander.org/vat-assignment-paused-for-now-but-will-it-be-pulled-for-good/

As you can see from our commentary, we were far from convinced that VAT assignment was sensible, even if it could be accurately estimated. This would open up the Scottish Budget to significant economic risk which the Scottish Government would have limited flexibilities to deal with.

Setting that aside, thought, it appears that after 8 years of work between the Scottish Government and HMRC, we are still in a situation where the estimates of VAT raised in Scotland are too volatile to be suitable for the purposes of VAT assignment. While the estimates are eminently fit for purpose for statistics, such as the ONS Country and Regional Public Sector Finances, the margins of error are too great to be used for budget setting purposes, especially as outturn will never be available.

It is time that both governments agreed that this is not a sensible idea and that VAT Assignment is abandoned.

Professor Mairi Spowage
Fraser of Allander Institute
November 2023

Finance and Public Administration Committee VAT assignment roundtable

Advance comments from Audit Scotland

Introduction

1. Audit Scotland welcomes the opportunity to participate in the Finance and Public Administration Committee's roundtable evidence session on VAT assignment in Scotland. We would offer these comments in advance of the session.

2. Audit Scotland is a statutory body established under the Public Finance and Accountability (Scotland) Act 2000. It is Scotland's national public sector audit agency which provides the Auditor General for Scotland and the Accounts Commission (who are responsible for the audit of local government) with the services they need to carry out their duties.

3. Our comments below are informed by the information currently publicly available on VAT assignment, including the experimental statistics and accompanying materials published by HMRC, the summary of the assignment model published by HM Treasury and the recently revised fiscal framework agreement between the Scottish and UK Governments. We also draw on our own initial analysis of the experimental HMRC statistics published for the period from 2011 to 2021. We note at the outset that these are not necessarily representative of the impact of the implementation of an agreed methodology from a yet to be determined future date.

Impact of VAT assignment on the Scottish budget

4. Under the fiscal framework agreed between the Scottish and UK Governments receipts from the first 10p of the standard rate of VAT and the first 2.5p of the reduced rate of VAT in Scotland are due to be assigned to the Scottish Government. This assignment is to be based on a methodology that will estimate expenditure in Scotland on goods and services that are liable for VAT. This is necessary because actual receipts are not distinguished between different areas of the UK. The approach is in line with the Smith Commission agreement.

5. Once introduced, assigned VAT (VA) will impact on the Scottish budget significantly. In the most recent experimental statistics published by HMRC the illustrative amount that would have been assigned to the Scottish budget for 2021/22 was £5.933 billion. The Scottish Fiscal Commission has forecast that assigned receipts will grow from around £6 billion in 2022/23 to over £7 billion in 2027/28. The fiscal framework also sets out how the Scottish Government's block grant would be adjusted, to account for the fact that part of the Scottish Government's spending power will be determined through AV. Details of how this will operate remain to be agreed and confirmed.

6. Once introduced VA is expected to impact on the Scottish budget broadly in line with other tax and social security powers that were devolved under the Scotland Act 2016. In particular:

   - Once VAT assignment is introduced, funding will be included in the annual Scottish budget based on forecasts of AV prepared by the Scottish Fiscal Commission. This amount will be locked in for the financial year, allowing the Scottish Government to draw down associated funding up to the amount forecast. A reduction will also be made to the block grant based on OBR forecasts of total UK VAT receipts, known as the Block Grant Adjustment (BGA). This will also not change during the year.

- Once data is available on the actual level of UK VAT receipts for a particular financial year (along with other data sources used to estimate VA), outturns[1] will be calculated for both AV and the associated BGA using an agreed estimation methodology. The subsequent Scottish budget will then be adjusted for the difference between forecast and outturn AV and for the difference between forecast and outturn of the associated BGA.

7. The BGA will be based on the VA outturn for the year immediately before the introduction of VAT assignment, which is then subsequently indexed. Indexation will be on a per capita basis (adjusted for relative population changes) in line with other elements of the fiscal framework such as Scottish Income Tax. Under the fiscal framework any adjustment required to the baseline BGA will be made at the same time as the reconciliation for the first year of operation.

8. This means that the overall impact on the Scottish Budget will be determined by the relative performance of the estimated Scottish VA share of UK VAT receipts compared to UK receipts from the point that VAT assignment is implemented - adjusted for differences in the respective rates of population growth.

Budget risks

9. The implementation of VAT assignment would further increase the uncertainty, volatility and complexity of the Scottish Budget. This would build on existing budget risks associated with relative economic performance (insofar are these translate to relevant tax receipts and spending pressures), forecasting (with budgets initially based on forecasts, and subsequently adjusted as results are established) and overall budget management (balancing spending with receipts, drawing on the reserve and borrowing powers agreed). We describe these risks in our briefing papers on the Operation of the Fiscal Framework.[2]

10. Budget risk is often seen in solely negative terms, but over time there may be either downside or upside outcomes. Downside risks increase the pressure on the available public resources, limit the range of policy choices available and curtail the effectiveness of the public spending programmes being pursued. Upside risks reduce the pressure on resources, enable a greater range of policy choices and extend the effectiveness of spending programmes.

Estimation risk

11. VAT assignment would also introduce significant estimation risk to the Scottish budget. This is because the VA amounts established are based entirely on estimates based on a model being developed jointly by the UK and Scottish Governments. There will be no 'actual' figure available at any stage. Because of the inherent uncertainty in any estimation, this means that this element of the budget will always include a degree of 'error' - that is the difference between the estimate and the actual figure. Unlike forecast error, this estimation error can

[1] The description ‘outurn’ is used here to describe the final result that will be applied to the Scottish budget. Because VA is estimated there will never be a known ‘actual’ amount of Scottish VAT receipts.

[2] Scotland's new financial powers: Operation of the Fiscal Framework 2018/19 (available here) and Scotland's new financial powers (available here).

never be known or corrected for. It is therefore important to have an overall sense of the likely extent and distribution of possible estimation errors.

12. The assignment model is based on many data sources, including ONS statistics and survey data. HMRC has assessed the statistical uncertainty (sampling error) in the VAT assignment model for the most significant data sources - the Office of National Statistics (ONS) Living Costs and Food Survey (LCF), Annual Survey of Hours and Earnings (ASHE) and the Business Register and Employment Survey (BRES). Taken together around 82% of VA is based on this data.

13. Using accepted statistical approaches HMRC has estimated 95% confidence intervals for these aspects of the 2017 VA share of £5.430 billion as:

- in the region of +/- £135 million (+/- 4.0%) for LCF survey data
- in the region of +/- £80 million (+/- 7.0%) for ASHE and BRES survey data combined.

14. HMRC's assessment gives an indication of the overall level of sampling error inherent in these aspects of the assignment model. HMRC also notes that the complexity of the assignment model means that it is possible that these initial findings have been underestimated. No overall assessment of statistical uncertainty is available. HMRC also identifies a number of potential sources of non-sampling error, but these are not quantified.

15. This estimation risk is likely to increase the inherent volatility of the Scottish budget. Estimated VA and the associated BGA would both be subject to a degree of variation year to year driven entirely by sampling (and potentially non-sampling) risk built into the estimation process - and not directly related to the underlying economic activity contributing to VAT receipts. It is not possible to determine the extent to which year-to-year changes in estimated VA is related to estimation risk and how much is related to economic factors.

Baseline effect

16. Based on the experimental statistics, it is clear that relative performance of estimated VA in the baseline year will have a significant impact on how VAT assignment affects subsequent budgets. Put simply, if the baseline was established during a year when Scottish AV was relatively high this would likely significantly reduce overall budgets when compared to the case where the baseline was established during a year when Scottish AV was relatively low.

17. For example, if VAT assignment had been implemented in 2021/22 using the current assignment model estimated AV grew by over 23% compared to the previous year, whereas total UK VAT receipts grew by under 14%. This scenario would have resulted in a significant increase to the Scottish budget - we estimate around £450 million in the first year of implementation - and the likelihood of relatively higher budgets in subsequent years. By contrast if VAT assignment had been implemented from 2018/19, we estimate that the budget would have been reduced by an average of around £290 million each year for the next four years.

18. These estimates are entirely illustrative, based retrospectively on the experimental statistics and the current assessment model that is yet to be agreed. The 2020 and 2021 figures were significantly affected by Covid-19 and are possibly an outlier. Nonetheless the sensitivity of future budget impact to this baseline effect is clear. At the point a future decision is taken to implement VAT assignment, relative performance for the baseline year will be unknown although forecasts will be available.

Volatility of estimates

19. Based on the experimental statistics, there is significant volatility from year-to-year in both Scottish estimated VA and the total UK VAT liability - and most significantly in the relative growth rates of both measures. It is this, adjusted for differences in population growth, that would drive the overall impact on the Scottish budget. If future experience followed a similar pattern this would result in significant additional volatility to the Scottish budget.

20. Over the period for which experimental statistics are available, the largest differences between Scottish estimated VA growth rates and UK VAT growth rates were in the years affected by Covid-19. Estimated VA growth was 92.9% of UK growth in 2020 and 108.7% in 2021. Variation was also significant in earlier years, with relative growth ranging between 96.7% in 2014 and 107.5% in 2017. Our illustrative analysis of the experimental statistics suggests that year-to-year changes to the overall budget could range from less than £10 million to more than £500 million if future experience followed a similar pattern. While the extent to which the impact was predominantly positive (increasing available budget) or negative was strongly affected by the baseline year (see above), we estimated under all scenarios the range of outcomes reflected this broad assessment of potential volatility.

21. This volatility is likely to be related to both estimation risk and the underlying economic factors driving the assignment model. It is not possible to establish the relative contribution of each of these factors.

22. It is important to recognise that the overall impact on the Scottish budget in any one year would depend on other sources of volatility (including the forecast reconciliation process) for both assigned VAT and the other mechanics of the fiscal framework. Because resource borrowing powers can only be used in specified circumstances (in-year cash management or forecast error), they would not be available to manage the inherent volatility in the ultimate impact of VAT assignment on the Scottish budget.

Underlying funding trends

23. The experimental statistics give an overall sense of what the overall trend in funding would have been during the period they cover if the VAT assignment had been in place using the current assignment model. At the headline level Scottish estimated AV has risen by 32% across the period, while UK VAT receipts rose by 38%. If a similar pattern was experienced once VAT assignment was implemented this could be expected to reduce the overall Scottish budget over time. While the effect would be mitigated to some extent by the adjustment for relative population growth in calculating the BGA, this would likely have a negative effect on spending power over the long term nonetheless.

24. How this would be experienced year-to-year would depend on the baseline and volatility factors discussed above. Our indicative analysis of the experimental statistics suggests that while annual changes would likely be a mix of positive and negative effects, the balance of budget impact was largely weighted to the downside. This is consistent with the relative estimated AV growth over the period.

25. Our indicative analysis is solely based on the experimental statistics available and does not incorporate any analysis of underlying economic activity, the extent to which this affects the assignment model or the outlook for this. Because it is fully reserved there is no scope for differences in VAT policy to have a direct effect on the funding position as is the case with other parts of the fiscal framework such as Scottish Income Tax or social security spending (we have previously referred to this as policy risk). Nonetheless in principle the broader policy choices of the Scottish Government may affect the rates of relative AV growth -

indeed this was the reasoning of the Smith Commission in supporting its aims for greater accountability.

26. It will be important to understand the link between economic performance, the relevant aspects of underlying economic activity and how this plays through to the assessment model. This will be key to understanding the how well the VAT assignment approach ultimately implemented supports greater accountability. The extent to which the 'noise' introduced by estimation risk obscures or suppresses underlying economic effects is a key element of this.

Transparency

27. Public and Parliamentary confidence in the validity and robustness of the assignment approach is essential - if it is to become an accepted feature of the Scottish budget process. This needs to be underpinned by transparency, clarity and understanding of how it operates and how effectively it supports accountability and financial responsibility.

28. The VAT assignment model is undoubtedly complex and draws from a myriad of data sources including official statistics, survey data and financial information. HM Treasury's summary of the assignment model provides a helpful overview of the calculation of annual estimates - including the main data sources and the link to the Scottish budget. Some further information is also provided about some important aspects of the model, and the assessment of the potential for estimation error. More detailed information is also made available to the Scottish Fiscal Commission to enable its forecasting role.

29. Nonetheless, there is no public visibility over the details of how the estimates set out in the experimental statistics have been calculated. This alongside, the inherent complexity of the approach, limits the ability of third parties to understand and provide commentary on the assignment model. This also potentially restricts Parliamentary scrutiny.

Verification and audit

30. The Smith Commission was clear that "receipts [assigned] should be calculated on a verified basis, to be agreed between the UK and Scottish Governments" (Para 84). The fiscal framework agreement provides that the two Governments will require to reach agreement on the assignment methodology, forecasting and reconciliation arrangements and a suitable point for commencement. Currently beyond this, it's not clear what form any 'verification' might take.

31. HMRC has published a quality report alongside its experimental statistics based on the current assessment model. This is a standard report accompanying official statistics and provides a range of information setting out its assessment of several matters relating to data quality including an overview of quality assurance arrangements and an assessment of accuracy and reliability. This provides helpful background and some commentary on important issues. In our view it is unlikely to be a sufficient on its own to provide the degree of verification that is likely to be necessary once VAT assignment is implemented. It has not been designed for this purpose.

32. Given the significance of VAT assignment to the Scottish budget, we anticipate that the Scottish Parliament will want to be sufficiently assured that the amounts assigned to the Scottish Government are appropriate, have been robustly estimated and reflect the agreed estimation approach. We recognise that this may include a wish for a degree of independent assurance about the amounts being applied to the Scottish budget.

33. We have been considering these issues carefully, although a greater understanding of the arrangements ultimately agreed will be needed before any decision on auditing can be made. Given the underlying nature of the estimation process we consider it unlikely that the final VAT assignment figures applied to the budget will be capable of being audited in a similar matter to other elements of the fiscal framework such as Scottish Income Tax outturns, devolved tax receipts or social security expenditure. We will continue to engage with the Scottish Government and other relevant parties on these issues.

Mark Taylor, Audit Director, Audit Scotland

October 2023

ANNEXE B

SPICe The Information Centre
An t-Ionad Fiosrachaidh

Finance and Public Administration Committee

Tuesday 14 November 2023

VAT assignment statistics

Introduction

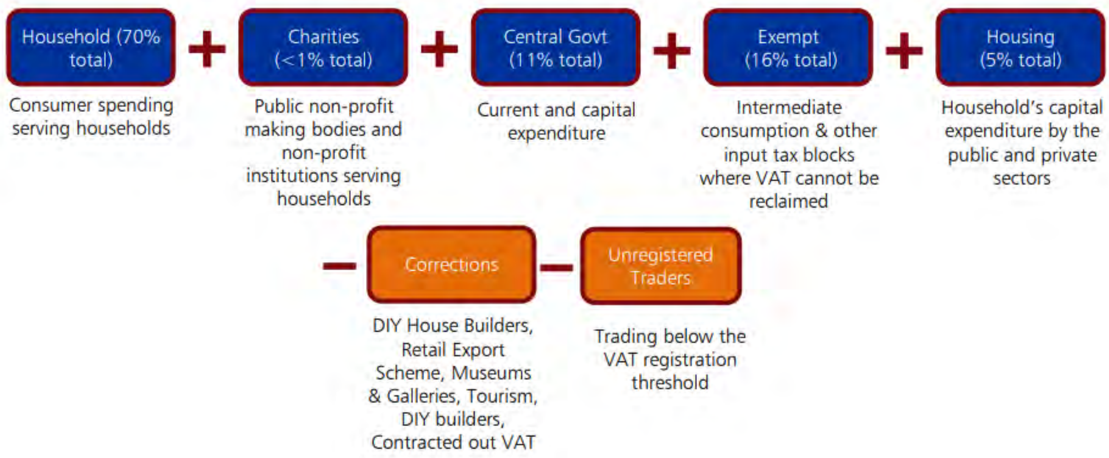
This paper summarises some of the issues arising from the Scottish VAT assignment experimental statistics. What these statistics make clear is that VAT assignment data fluctuates to a larger extent than the other devolved taxes. As the Finance and Constitution Committee found when it looked at VAT assignment in the previous Parliamentary session, this is a key reason behind a lack of progress in implementation of the Smith Commission recommendation that VAT be assigned to the Scottish budget.

The VAT assignment model

The Scottish VAT Assignment: Summary of Assignment model publication of 2018 set out the agreed methodology for assigning a Scottish share of VAT.
HMRC VAT compliance work does not specify which UK region goods and services liable to VAT were consumed. To calculate the Scottish share of UK VAT, a VAT assignment model was required to estimate the VAT incurred on goods and services consumed in Scotland compared with other UK regions.

So how does the assignment model calculate Scottish share of VAT?
In short, the model uses UK expenditure data, together with Scottish shares of that expenditure, and applies relevant VAT rates to derive an estimate of the VAT receipts attributable to consumption in Scotland. This model therefore calculates the VAT Total Theoretical Liability (VTTL) for Scotland. The VTTL is a measure of the theoretical VAT collected by a jurisdiction's tax authority assuming there are no losses in collections from non-compliance.

The VAT assignment model is made up of five spending components and two adjustment components. These are as follows:



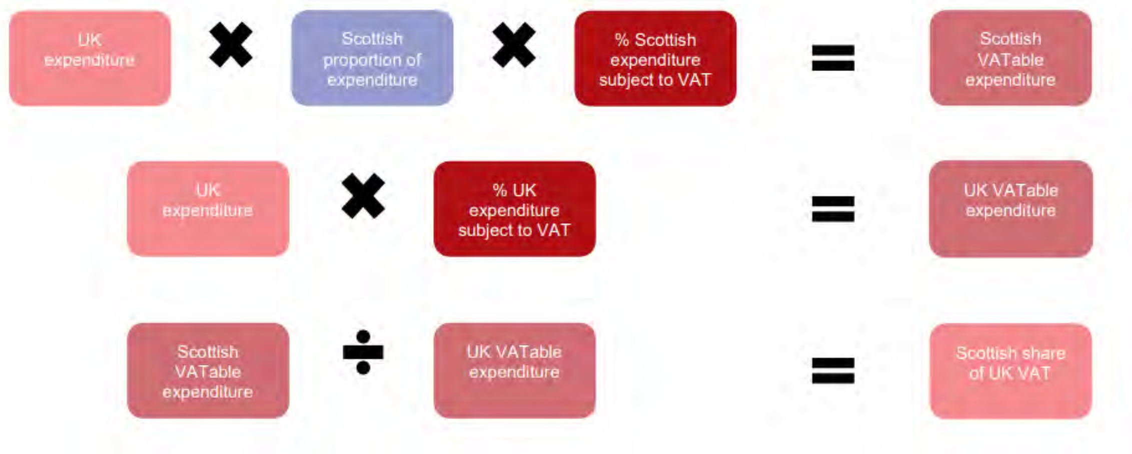
The VAT Assignment model takes the expenditure in Scotland in each of the above expenditure components and then estimates the amount of that expenditure that is subject to VAT. This can be compared to the same expenditure component analysis for the whole of the UK to calculate the Scottish share of UK VAT. The Scottish share of VAT can then be applied to VAT receipts to calculate the Scottish share of UK VAT receipts.

The model analyses these expenditure components using data from multiple, mostly publicly available, sources of information including, but not restricted to: the ONS Blue Book, ONS Living Cost and Food Survey, ONS International Passenger Survey, VisitBritain and Statistical tables published by other government departments.

The VAT liability of the expenditure components outlined above is determined by the VAT treatment of the goods and services that are included in the expenditure component. Although most goods and services are subject to 20% VAT, many are subject to the zero and reduced rates (5%) of VAT. Therefore, expenditure categories need to be disaggregated to goods and services that have consistent VAT rate treatment in order to accurately calculate the VAT liability relating to that expenditure.

For example, certain foods in the UK are subject to the zero rate of VAT. The model must therefore disaggregate food expenditure by type of food in order to determine the proportion of food consumption which is subject to VAT at 20%. This analysis can then be used to calculate the VAT liability of the total food expenditure.

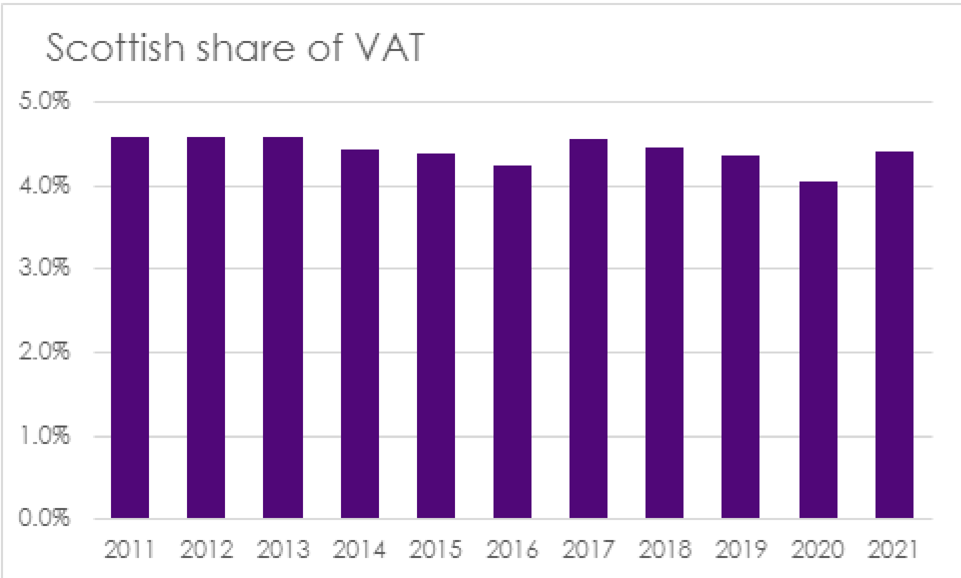
Simplified calculation of Scottish share of UK VAT

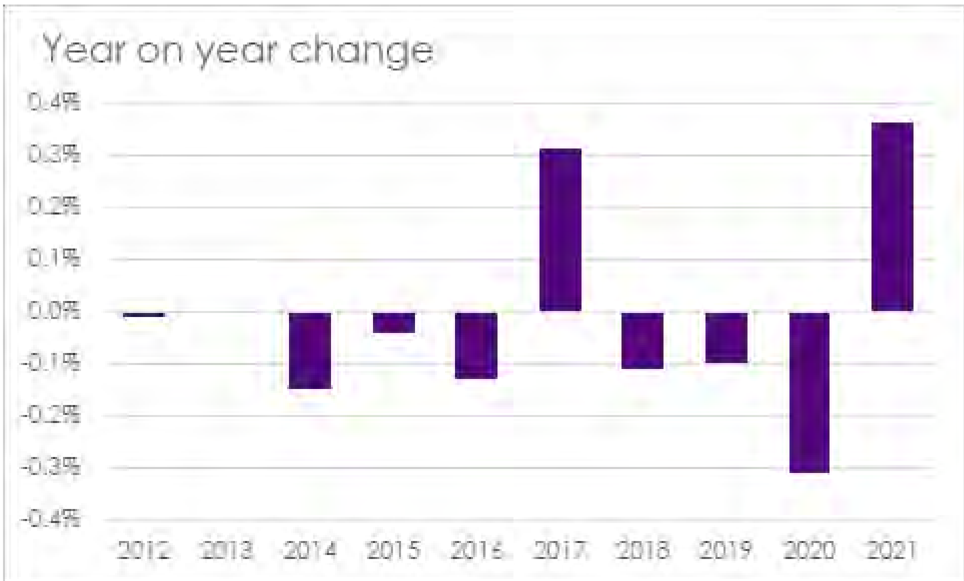


What the experimental statistics show

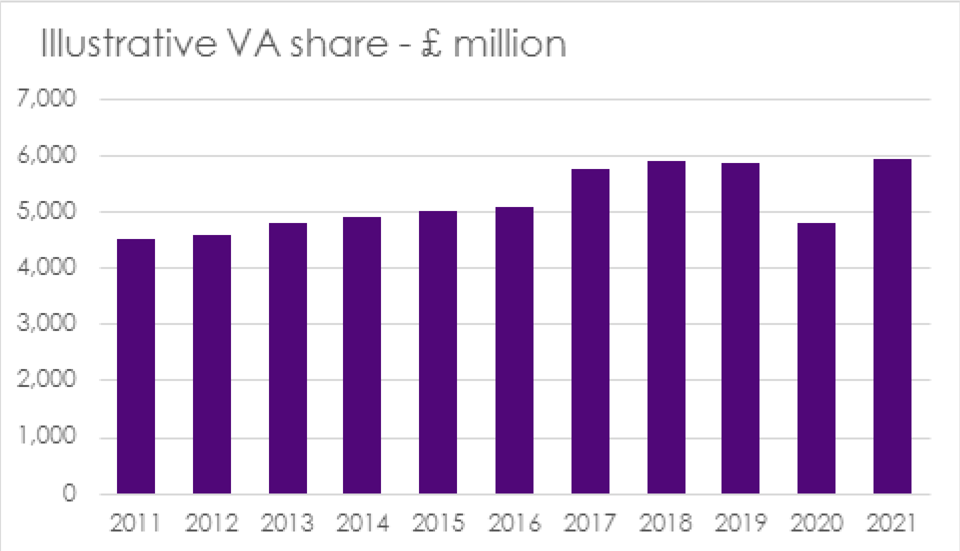
The most recent Experimental statistics on VAT Assignment (VA) for Scotland were published on 28 September 2023. These are produced by HMRC with support from the Scottish Government.

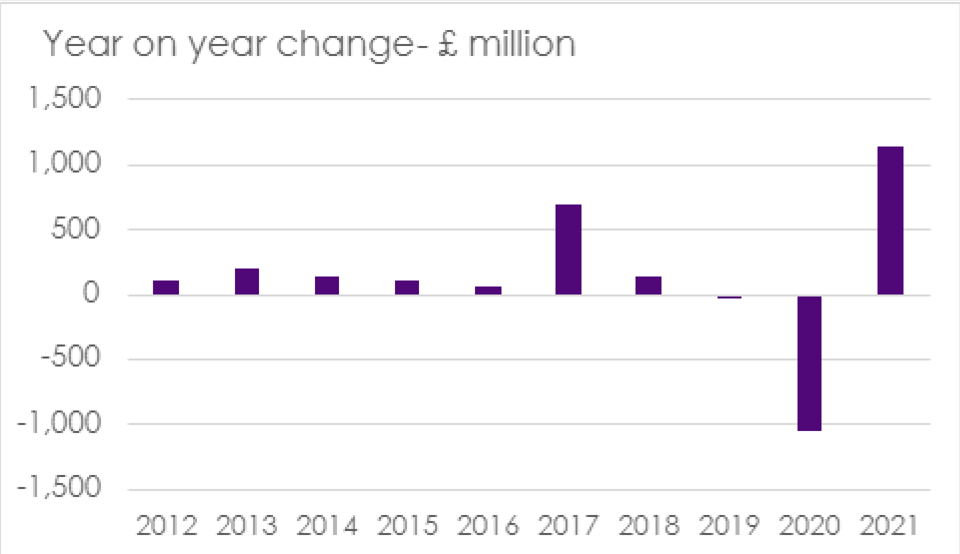
The following visuals shows the degree to which Scottish VAT assignment has fluctuated as a share of UK VAT receipts.





And what this has meant in revenue terms and how that has changed year-on-year.

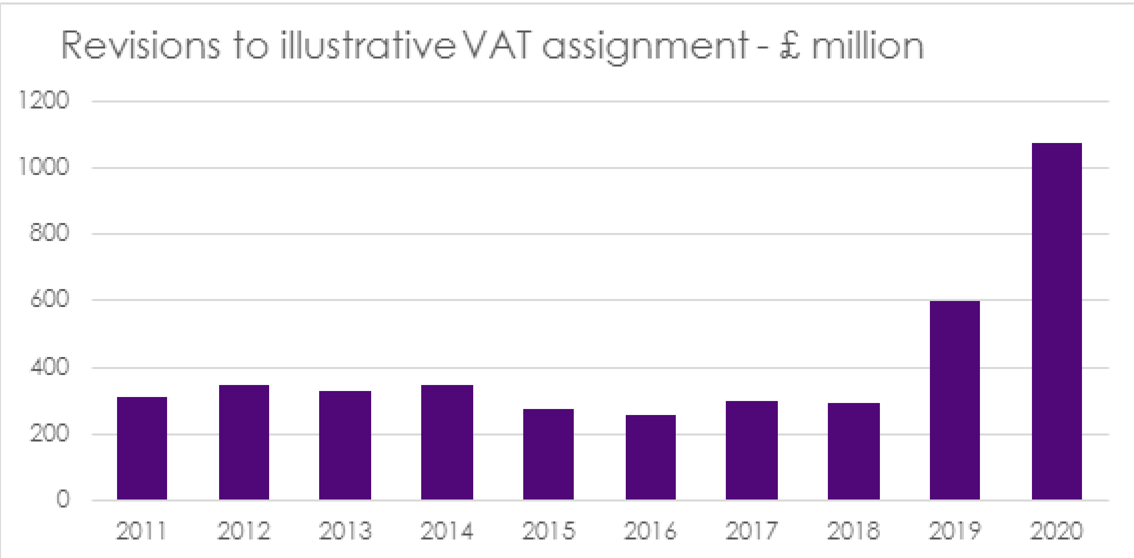




Main points to note from the above charts are as follows:

- The Scottish VA share fluctuates between 4.03% and 4.57% during the period 2011 to 2021.
- The VA share was lowest in 2020 at 4.03% due to COVID-19 effects, in particular lower domestic tourism expenditure in Scotland from rest of the UK (rUK) residents.
- The VA share has recovered in 2021 to 4.39%; this increase has been driven mostly by recoveries in domestic tourism expenditure in Scotland, closely followed by growth in household expenditure.
- Across the rest of the time series, fluctuations in VA share are mostly driven by changes in household expenditure, which is the largest expenditure sector of the model.

The data is also subject to revisions which are presented in the following chart. These have typically been around the +£300 million mark, but there were large revisions made to the initial 2019 and 2020 figures. This raises questions discussed below around how any kind of reconciliation process would work, given the scale of the revisions which have taken place over the period covered by the data.



The Scottish VA share has been revised in all years as underlying National Accounts aggregates have been revised. These have increased the VAT assignment figures, as shown in the above chart.

Are we any further forward?

It appears that we remain some way from solving the issues arising from VAT assignment uncertainty. There is nothing in the public domain to suggest that the Scottish and UK government are any further forward in addressing the concerns raised when the previous Parliament's Finance and Constitution Committee considered this issue in [2018 in its pre-Budget scrutiny report.](#) That Committee was concerned that VAT was being assigned to the Scottish budget based on estimates from a model, rather than actual outturn numbers as happens with income tax and the fully devolved taxes. It concluded as follows:

> “The Committee is concerned that basing VAT assignments for Scotland on estimated figures could potentially introduce further volatility into Scotland’s public finances. The Committee recommends that both Governments should continue to review the methodology used for assigning VAT to Scotland during the implementation year to ensure its robustness and reduce the level of risk from forecast error.”

The Scottish VAT Assignment: Summary of Assignment model publication of 2018 remains the model used for publishing VAT assignment data, and it is still based on estimates.

The VAT Assignment model also states that:

> “The block grant adjustment for VAT assignment will work in broadly the same way as the adjustments applied for Scottish Income Tax.”

However, one crucial difference is that Scottish Income tax is based on outturn data, whereas there is still no mechanism for basing VAT assignment on any kind of audited set of outturn information.

There are also questions on how the significant revisions highlighted above would be accounted for and accommodated by the Fiscal Framework? These have typically been of the order of £300 million, but rose to around £600 million in 2019 and over £1 billion in 2020.

Ross Burnside
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