The VAT opportunity

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FAST FACTS

- The Scottish Parliament now raises taxes which cover about 40% of its expenditure. NSND income tax makes up the vast majority of that revenue.
- The Calman Commission decided not to recommend devolving all of income tax because it would leave the Scottish Budget "*so heavily dependent on one single tax*" and that "*governments seek to operate a broad tax base in order to mitigate variations in one particular component of that tax base*"
- Both the Calman and Smith Commissions highlighted the attractiveness of VAT as a potential devolved tax, but recognized that it could not be done due to EU law.
- The Scottish Conservatives official submission to the Smith Commission went as far as suggesting that the Party would have called for the tax to be devolved had it not been for EU law.
- Reform Scotland believes that as the UK is leaving the EU and that law will no longer apply, the UK Government should make a commitment now to devolve VAT once Brexit is complete.
- Devolving VAT would help re-balance Holyrood's tax & expenditure powers. Holyrood would go from being responsible for nearly 30% of revenue and 60% of expenditure, to nearly 50% of revenue and 60% of expenditure.
- It would also mean that Holyrood would be responsible for the majority of its expenditure for the first time as well as reducing the over-reliance on NSND income tax revenue

CONTEXT

The Scottish Parliament has been in existence for nearly 20 years and while policies north and south of the Border have frequently differed, this is the first time that the Scottish Government has had the power to alter one of the main taxes. There is now real differentiation on income tax policy.

The Scottish Parliament now raises taxes that cover approximately 40% of what it spends. Income taxes represent by far the biggest element of Holyrood's tax powers, some two-thirds of its aggregate taxing capacity, as illustrated below[1]:

Tax	Amount raised in 2016/17 (£m)	% of Holyrood's tax revenue
NSND Income Tax	11,313	66%
Non-Domestic Rates	2,732	16%
Council Tax	2,082	12%
Land & Buildings Transaction Tax	466	3%
Air Passenger Duty	264	2%
Scottish Landfill Tax	149	1%
Aggregates Levy	59	0%
Total	17,065	100%

While the increase in tax powers is a welcome movement towards Reform Scotland's proposal of 'Devo Plus', the point we have reached is hardly rational. With a single tax representing such a large part of Holyrood's resources, and especially one so potentially influential on labour mobility within the UK single market, Holyrood must act wisely to avoid unpleasant unintended consequences.

[1] Although NSND income tax figures are only fully devolved from 2018/19, estimates based on the 2016/7 figures are detailed in the 2016-17 Government Expenditure and Revenue Scotland publication.

The next stage towards Devo Plus should be further devolution of important taxes. Perhaps the more immediate prospect is the devolution of VAT following Brexit. The only reason that it was not devolved at the same time as income tax was the UK's membership of the EU which insists on common rates of VAT across member states.

Indeed, the Scottish Conservative Party's official submission to the Smith Commission stated:
"*Were it not illegal under EU law, we would have been inclined to recommend that VAT be devolved to the Scottish Parliament*"

BACKGROUND

The Scotland Act 2016 assigned 10p of VAT to Scotland. It did not devolve it. The power to change the rate, or to what it applies to, remains at Westminster, which is why Reform Scotland has never included it in any of our calculations for Holyrood's tax powers..

Value-Added Tax (VAT) is a type of sales tax that applies to VAT-registered businesses when, for example, they sell goods and services. According to the latest edition of GERS (2016/17), it is the third largest source of tax revenue in both the UK and Scotland. It raised £121.5 billion across the UK in 2016/17, and £10.2bn in Scotland. The larger revenue raising taxes, Income Tax and National Insurance Contributions, raised £12.7bn[2] and £10.4bn respectively.

The UK has a standard 20% rate; a reduced rate of 5%; and a zero rate.[3] The Scotland Act 2016 allows for the first 10p of the standard rate of VAT receipts and the first 2.5p of the reduced rate of VAT receipts in Scotland to be assigned to the Scottish Government, from 2019-20.[4]

At the time of the Smith Commission and the 2016 Scotland Act, many references were made to the fact that VAT would be a good tax to devolve were it not for EU regulations.

The Scottish Conservative's submission to the Smith Commission went as far as saying that if it were not for EU rules, the party would probably have called for the tax to be devolved:

"*Devolution of VAT is unlawful in EU law (which requires each Member State to set a uniform rate across its territory). This is unfortunate, as VAT – like income tax – is in principle suitable for devolution. Sales taxes are commonly decentralised – even down to local level – in countries such as Canada and the US. Further, VAT is a growth tax, which supports the sorts of services devolved governments provide.* ***Were it not illegal under EU law, we would have been inclined to recommend that VAT be devolved to the Scottish Parliament****.*"[5]

As the legislation was passing through Westminster, David Gauke, then Chief Secretary to the Treasury, told the House of Commons on 9th December 2015

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[2] £12.7bn is the total figure of income tax raised in Scotland in 2016/7 and therefore includes savings and dividends income tax, which is not devolved to Scotland.
[3] https://www.gov.uk/vat-rates
[4] http://www.gov.scot/Publications/2017/08/7201/6
[5] Scottish Conservatives, Commission on the Future Governance of Scotland, May 2014 http://webarchive.nationalarchives.gov.uk/20151202171105/http://www.smith-commission.scot/resources/political-party-proposals/

"The Smith commission set the objective that more devolved spending in Scotland should come from tax raised in Scotland. Control over setting VAT rates is not being devolved to Scotland, because EU VAT law does not allow for differential VAT rates within a member state"

Within the European Union the VAT Directive limits the abilities of member states with regard to the use of the tax.

The aim of the directive was to move toward harmonizing VAT across member states.

As a result of this directive, the ability of both the UK Government to devolve the tax, or the Scottish Government to change the regime is hampered.

However, on 23rd June 2016, the UK voted to leave the EU. As a result, when the UK does leave the EU, the directive on VAT will no longer apply to the UK.

The comments from both the Conservative Government at Westminster and the Scottish Conservative's submission to the Smith Commission, both clearly inferred that VAT was not being devolved to Holyrood simply because EU law meant that it could not be.

The decision to leave the EU has removed that barrier. There is no reason why the UK Government could not give a commitment now to devolve VAT once the UK has left the EU.

POLICY RECOMMENDATIONS

Devolve VAT to Holyrood

Even as far back as the Calman Commission, the potential of VAT being a good tax to deliver accountability was recognised. It noted:

"*VAT has the potential to deliver accountability given its significant yield and the transparency to the population. VAT receipts are also directly related to the performance of the economy*".[6]

This link was highlighted again by the Smith Commission, which called for a level of assignation.

Neither commission considered VAT devolution because it could not be done under EU law.

That barrier has been lifted, but the link between the tax and economic performance remains. Balancing income and consumption taxes makes obvious sense. Indeed the words of the various commissions and politicians over the years across different parties have agreed with this point, but have had to rule it out because of the EU directive.

Reform Scotland believes that as the UK is leaving the EU, the UK Government should make a commitment now to devolve VAT once Brexit is complete.

[6] Commission on Scottish Devolution, "Serving Scotland Better: Scotland and the United Kingdom in the 21st Century", June 2009, paragraph 3.119

As the tables below illustrate, if VAT was devolved to Holyrood, it could mean that Holyrood's lean towards expenditure, as opposed to also tax raising, would begin to be re-balanced.

Holyrood would go from being responsible for nearly 30% of revenue and 60% of expenditure, to nearly 50% of revenue and 60% of expenditure. It would also mean that Holyrood would be responsible for the majority of its expenditure for the first time (at 60%) and lessen the over-reliance on NSND income tax revenue.

The changing balance of Holyrood's tax powers and impact of adding VAT

Figures from GERS 2016/16 tables - http://www.gov.scot/Resource/0052/00524135.xls

£m	Total Scottish revenue (inc North Sea Oil)	Total devolved revenue[1]	Devolved revenue as % of total		Total Scottish expenditure	Total devolved expenditure[2]	Devolved expenditure as % of total		Devolved revenue as % of devolved expenditure
1999/2000	32,146	2,703	8.41%		33,784	19,137	56.65%		14.12%
Scotland Act 2012[1]	57,952	10,029	17.31%		71,209	42,103	59.13%		23.82%
Scotland Act 2016[2]	57,952	17,066	29.45%		71,209	44,893	63.04%		38.01%
Scotland Act 2016 + VAT[3]	57,952	27,259	47.04%		71,209	44,893	63.04%		60.72%

Notes
1. Although the Scotland Act was passed in 2012, 2016/17 was the first tax year that all the new powers were in place, and the figures are based on that year in GERS.
2. 2016/17 is the latest set of GERS figures available, therefore estimates for the new powers have been made using the additional GERS tables.
3. According to GERS in 2016/17 VAT raised £10.2bn

Tax basket including VAT

Tax	Amount raised in 2016/17 (£m)	% of Holyrood's tax revenue
NSND Income Tax	11,313	42%
VAT	10,193	37%
Non-Domestic Rates	2,732	10%
Council Tax	2,082	8%
Land & Buildings Transaction Tax	466	2%
Air Passenger Duty	264	1%
Scottish Landfill Tax	149	1%
Aggregates Levy	59	0%
Total	27,259	100%