

# Unfinished Business

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## FAST FACTS

- Both the Calman and Smith Commissions highlighted the attractiveness of VAT as a potential devolved tax.
- The Scottish Conservatives official submission to the Smith Commission suggested that the Party would have called for the tax to be devolved had it not been for EU law.
- Local and regional sales taxes operate in other countries including the USA and Canada.
- The UK left the EU on 31 January and therefore the rules covering VAT restrictions within individual countries will no longer apply.
- Given previous political agreement that it would make sense to devolve VAT, the UK Government should take the opportunity afforded with Brexit and pass the tax to Scotland.
- Devolving VAT would also help re-balance Holyrood's tax & expenditure powers

## CONTEXT

Reform Scotland believes that in order to improve accountability and transparency at Holyrood it is necessary for the Scottish Parliament to raise more of the money that it spends.

The current financial settlement has left Holyrood hugely reliant on a single income stream. Non saving non dividend (NSND) income tax revenue accounts for 65% of all devolved revenue.

To put that in a wider context, income tax accounts for only 24% of UK revenue.

The Calman Commission, published in 2009, noted that “governments seek to operate a broad tax base in order to mitigate variations in one particular component of that tax base”<sup>1</sup>

Yet, the current arrangements do not allow for this.

The Calman, and subsequent Smith Commission, both highlighted the potential of devolving VAT to help create a basket of taxes. However, this could not be done due to EU rules.

The UK left the EU on 31 January 2020, removing this obstacle. Therefore, Reform Scotland is calling on the UK Government to devolve VAT to Scotland.

<sup>1</sup> Commission on Scottish Devolution, Final Report, para 3.168

## BACKGROUND

Value-Added Tax (VAT) is a type of sales tax that applies to VAT-registered businesses when, for example, they sell goods and services. The UK has a standard 20% rate; a reduced rate of 5%; and a zero rate.<sup>2</sup>

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.<sup>3</sup>

According to the latest edition of GERS (2018/19), it is the second largest source of tax revenue in Scotland and third largest across the UK. It raised £132.6 billion across the UK and £11.2bn in Scotland.

It is worth stressing that the amount of VAT raised in Scotland, and subsequently the assigned element, is estimated as businesses do not report VAT separately for Scotland.

The Scottish and UK Governments have been working to develop a VAT assignment methodology to estimate the VAT incurred on goods and services which are consumed within Scotland compared with other UK regions.

According to The Treasury's summary document, the VAT assignment model

*“calculates the theoretical proportion of UK VAT that would arise in Scotland in the absence of any compliance losses. This is calculated by multiplying comprehensive categories of expenditure in Scotland by their appropriate VAT rates, allowing for any other relevant rules determining liability for tax, and calculating the share that this represents of the Total UK VAT”.*<sup>4</sup>

Using these estimates, the revenue from the assigned element of VAT attributed to Scotland in 2018/19 was £5.6 billion.<sup>5</sup>

## Case for devolution

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”.*<sup>6</sup>

It is worth noting that the 2009 Commission decided not to devolve all of income tax to Scotland 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

<sup>2</sup> <https://www.gov.uk/vat-rates>

<sup>3</sup> <http://www.gov.scot/Publications/2017/08/7201/6>

<sup>4</sup> <https://www.gov.uk/government/publications/scottish-vat-assignment-summary-of-vat-assignment-model>

<sup>5</sup> GERS 18/19 Table 4.3

<sup>6</sup> Commission on Scottish Devolution, “Serving Scotland Better: Scotland and the United Kingdom in the 21<sup>st</sup> Century”, June 2009, paragraph 3.119

*variations in one particular component of that tax base”<sup>7</sup>*

This potential of devolving VAT was highlighted again by the Smith Commission.

The Scottish Conservative’s submission highlighted the benefits of devolving VAT and pointed to overseas examples of decentralised sales tax. The party stated that if it were not for EU rules it would likely call 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.***

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

*“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 was blocked.

The Scottish Conservatives highlighted in their Smith submission that sales taxes are commonly decentralised in a number of countries.

For example, in the USA there is no federal sales tax, but there are several different local and state sales taxes.

In Canada there is a federal Goods and Services Tax (GST) as well as Provincial Sales taxes.

In India the central government imposes a Central Sales Tax while states impose their own different sales taxes.

<sup>7</sup> Commission on Scottish Devolution, Final Report, para 3.168

## POLICY RECOMMENDATIONS

### Devolve VAT to Holyrood

Politicians from across the political spectrum, including senior Conservatives, have recognized the potential benefits of devolving VAT in full.

Therefore, as Brexit removes the obstacle to devolution, Reform Scotland believes VAT should be devolved.

Devolving VAT will also give Holyrood a better basket of taxes. Currently 65% of the Scottish Parliament's tax revenue comes from NSND income tax. By devolving VAT, that reliance would fall to 40%.

	20108/19		2018/19 +VAT	
	£m	% of Holyrood's tax basket	£m	% of Holyrood's tax basket
NSND income tax	11,486	64.6%	11,486	39.7%
VAT	0	0	11,153	38.5%
NDR	2,847	16.0%	2,847	9.8%
Council Tax	2,360	13.3%	2,360	8.2%
LBTT	557	3.1%	557	1.9%
Air Passenger Duty*	338	1.9%	338	1.2%
Scottish Landfill Tax	143	0.8%	143	0.5%
Aggregates Levy*	57	0.3%	57	0.2%
<b>Total</b>	<b>17,788</b>	<b>100%</b>	<b>28,941</b>	<b>100%</b>

\*Date of devolution of these taxes is yet to be decided