

## Summary

The Scottish Government is committed to creating an environment in which businesses have an opportunity to flourish, underpinned by a fair and efficient taxation system.

Since 2007, we have taken forward a range of initiatives to make Scotland the most competitive location in the UK to do business. For example, our highly successful Small Business Bonus Scheme has eliminated the business rates burden on tens of thousands of properties across Scotland and reduced the tax burden on thousands more.

However under the current constitutional arrangements, control of many of the key job creating powers are reserved. Corporation tax is one of the chief levers that government can use to promote growth, investment and jobs. Used wisely, and as part of an overall economic strategy, it can be a vital source of competitive advantage.

Modelling by the Scottish Government highlights that pre-announcing a reduction in corporation tax in Scotland equivalent to a fall from 23% to 20% can increase the level of output by 1.4%, boost overall employment in Scotland by 1.1% (equivalent to 27,000 jobs) and raise overall investment in the Scottish economy by 1.9% after 20 years.

The UK Government is considering lowering corporation tax in Northern Ireland, making it all the more essential that Scotland gains responsibility for this important tax power to help boost the Scottish economy and create jobs.

A brief summary of the proposition is outlined below:

- The Scotland Bill should be amended to devolve corporation tax to the Scottish Parliament, with a like-for-like adjustment to the Scottish Budget. The net cost to the UK Exchequer would be zero;
- Following devolution, the Scottish Government would be responsible for the setting and collection of corporation tax receipts in Scotland;
- The Scottish Government is currently engaging<sup>1</sup> with businesses, investors, trade unions, academics and leaders from the third sector and the public sector regarding the best corporation tax regime for Scotland. This feedback will inform the corporation tax system the Scottish Government will introduce.

<sup>1</sup> "Corporation Tax: Discussion Paper Options for Reform", Scottish Government 16<sup>th</sup> August 2011  
<http://www.scotland.gov.uk/Publications/2011/08/corporation-tax-paper>

## Current Arrangements for Corporation Tax

Corporation tax is levied on company profits, with the amount paid dependent upon two components – the tax base and the tax rate. The tax base defines the element of a company's profit that is subject (or "liable") to be taxed while the tax rate is the amount of this "taxable" profit required to be paid.

Control over corporation tax is reserved to the UK Government. The main rate of corporation tax is currently set at 26%, companies with taxable profits of up to £300,000 are subject to a reduced "small profits rate" of 20%, and there is a system of marginal relief for companies with profits between £300,000 and £1,500,000.

There are no separately collected figures on the amount of corporation tax raised in Scotland. Figures compiled by HMRC are not disaggregated below the UK level.

However, the National Statistics "Government Expenditure & Revenue Scotland" publication provides an estimate of corporation tax revenue generated in Scotland. This is calculated by assigning a share of UK corporation tax receipts to Scotland based on the proportion of UK profits estimated to be generated in Scotland. In other words, and consistent with the fact that corporate profits are taxed according to location of activity, the estimate is based on the proportion of economic activity estimated to have been undertaken in Scotland.

The latest statistics estimate that total on-shore receipts (i.e. excluding North Sea revenues) in Scotland from corporation tax were £2,597m in 2009-10. Table 1 highlights how both Scottish and UK corporation tax on-shore receipts have changed since 2005-06.

<b>Table 1: Tax Revenue from Corporation Tax (excluding North Sea), £ million</b>					
	<b>2005-06</b>	<b>2006-07</b>	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>
Scotland	2,935	3,255	3,472	2,712	2,597
UK	34,278	37,307	40,384	32,493	29,968

Source: Government Expenditure & Revenue Scotland 2009-10, June 2011

Although corporation tax receipts in Scotland – and indeed the UK – have been relatively volatile in recent years as a result of the recession, corporation tax generates a relatively small proportion of total tax revenue in Scotland. For example, corporation tax receipts in Scotland accounted for around 6.2% of total estimated on-shore tax revenue generated in Scotland in 2009-10. Such volatility could be managed by giving the Scottish Parliament

greater fiscal responsibility, including greater revenue borrowing autonomy and responsibility over more stable tax revenues such as excise duty on alcohol.

### **Rationale for Scotland Securing Responsibility for Corporation Tax**

Governments' can influence economic activity through the use of a variety of economic levers, including the tax and regulatory environment. Corporation tax is a key determinant of competitiveness and can be integral to a country's economic strategy. Indeed reducing corporation tax is at the heart of the current UK Government's growth strategy.

### ***Corporation Tax & Economic Growth***

It is widely accepted that the taxation of companies is a key determinant of economic competitiveness. Within this, corporation tax is arguably the most significant element.

A competitive corporation tax system can benefit an economy through a number of different channels:

- Boosting corporate incentives to invest in physical and human capital, and in research and development;
- Lower rates of corporation tax increase firms' profitability and ability to compete in both domestic and overseas markets; and
- A competitive corporation tax structure can make a country more attractive as a location for enterprise relative to other tax jurisdictions.

There is a significant body of research studying the link between corporation tax and economic growth. For example, recent empirical work in the American Economic Journal shows that in the OECD, a 10% reduction in corporation tax has typically increased investment rates by over 2% points, doubled the number of entrepreneurs per 100 population and raised company registrations by 20%<sup>2</sup>.

Elsewhere, a seminal econometric study by American economists Lee and Gordon (2005) found that in a sample of 70 countries over a thirty year period, and after controlling for other growth factors, lowering corporate tax rates by 10 percentage points was estimated to have led to economic growth increasing by between 1 and 2 percentage points per annum<sup>3</sup>. While

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<sup>2</sup> Djankov, Simeon, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer. 2010. The Effect of Corporate Taxes on Investment and Entrepreneurship. *American Economic Journal: Macroeconomics*, 2(3): 31-64.

<sup>3</sup> Lee Y., and Gordon R.H., 2005, "Tax structure and Economic Growth", *Journal of Public Economics*, Vol. 89, pp. 1027-1043.

such studies can be difficult to interpret, they do suggest that there is a link between corporation tax and economic growth, if used wisely.

Closer to home, modelling work<sup>4</sup> undertaken by the Economic Advisory Group of the Northern Ireland Executive estimated that if Northern Ireland pre-announced a reduction in corporation tax to 12.5% and introduce the policy in 2014, it would increase the rate of growth by 1% point per year and generate 58,000 more jobs by 2030. Overall, the lower corporation tax rate is estimated to increase the standard of living in Northern Ireland by 13.5%.

In addition to stimulating domestic investment, there is a broad spectrum of evidence that suggests a competitive corporation tax regime can result in higher levels of international investment. Indeed this is supported by the conclusions in the HM Treasury paper on *'Rebalancing the Northern Ireland Economy'*, which states that in a world of increasingly mobile capital, business taxes are an important determinant of the attractiveness of a country to foreign investment<sup>5</sup>.

### ***Specific Challenges Facing the Scottish Economy***

The Scottish Government welcomes the UK Government's commitment to lowering the headline corporation tax rate. However, a unified UK rate of corporate tax is neither desirable nor economically efficient.

Clearly parts of the UK such as London and the South East already have an in-built competitive advantage over not only Scotland but also other parts of the UK such as Northern Ireland. Control over the corporation tax would provide a range of options for the Scottish Government to address this imbalance.

One of the reasons behind Scotland's relatively poorer long-term economic performance over the past 30 years has been the relatively smaller corporate sector in Scotland. For example, the overall business base in Scotland accounts for only a 6.9% share of total UK

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<sup>4</sup> <http://www.eagni.com/fs/doc/publications/impact-of-corporation-tax-on-ni-eag-report-final-report.pdf>

<sup>5</sup> [http://www.hm-treasury.gov.uk/consult\\_rebalancing\\_ni\\_economy.htm](http://www.hm-treasury.gov.uk/consult_rebalancing_ni_economy.htm)

turnover from VAT/PAYE registered enterprises in 2010, below our UK population share of 8.4%.<sup>6</sup>

Traditionally, the level of business start-ups in Scotland have been lower than elsewhere in the UK. Between 2002 and 2009, business start-ups per 10,000 adults in Scotland, as proxied by new VAT registrations, were over 30% lower than the UK average<sup>7</sup>.

Furthermore, business investment by firms in Scotland has also traditionally been less than in other parts of the UK and in small EU countries. In 2009, the value of business enterprise research and development (BERD) in Scotland was £644 million, 4% of the UK total - less than half of Scotland's share of UK population or GDP<sup>8,9</sup>.

The corporation tax system could help address many of these economic challenges. It could act as a greater incentive for Scots to start up their own business, provide Scottish firms with a competitive edge to help them grow and be more successful. Firms would have greater profits to re-invest within their business which could act to strengthen Scotland's corporate sector.

The Scottish Government believes that the body of evidence points towards an important link between corporation tax and investment, economic growth and jobs. As our discussion paper sets out<sup>10</sup>, ultimately it is how corporation tax is used alongside other key policy levers that determines the relative success of the policy, but used wisely the impacts could be significant.

## **Devolving Corporation Tax in Scotland**

The Scottish Government believes that there is a strong case for devolving corporation tax to the Scottish Parliament. The Scottish Government is responsible for the performance of the Scottish economy, however we lack many of the key job creating powers – such as corporation tax – which could make a difference.

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<sup>6</sup> Table B1.3 of 'UK Business: Activity, Size and Location - 2010. Available here: <http://www.statistics.gov.uk/STATBASE/Product.asp?vlnk=933> Note these statistics refer to the number of businesses based in Scotland rather than businesses operating in Scotland.

<sup>7</sup> <http://www.scotland.gov.uk/Topics/Statistics/Browse/Business/TrendData>

<sup>8</sup> UK Business Enterprise Research and Development, December 2010. <http://www.statistics.gov.uk/STATBASE/Product.asp?vlnk=8206>

<sup>9</sup> Scotland's share of the UK population in 2008-09 was 8.4 per cent. Scotland's share of UK less extra-regio GVA was 8.2 per cent (General Registers for Scotland and ONS Regional Accounts).

<sup>10</sup> "Corporation Tax: Discussion Paper Options for Reform", Scottish Government 16<sup>th</sup> August 2011 <http://www.scotland.gov.uk/Publications/2011/08/corporation-tax-paper>

Given that the UK Government is currently considering whether to allow a different corporation tax rate in Northern Ireland, there is a point of principle and fairness that the Scottish Government has a similar opportunity to consider using this key economic lever.

This position was supported by the cross-party Scotland Bill Committee of the last Scottish Parliament which concluded that any discussions over devolving corporation tax should involve all the devolved nations:

“the Committee’s view is that if a scheme to vary corporation tax were to be available in some of the devolved countries of the UK as a tool of the UK Government’s regional economic policy, it should be available as an option for a Scottish Government to use also. Any discussions about this should involve all the devolved nations.”  
Scotland Bill Committee Report<sup>11</sup>

The Scottish Government’s proposition for devolving responsibility for corporation tax to the Scottish Parliament is summarised in Box 1:

#### **Box 1: Proposition for Devolving Corporation Tax**

- The Scotland Bill should be amended to devolve corporation tax to the Scottish Parliament, with a like-for-like adjustment to the Scottish Budget. The net cost to the UK Exchequer would be zero;
- Following devolution, the Scottish Government would be responsible for the setting and collection of corporation tax receipts in Scotland;
- The Scottish Government is currently engaging with businesses, investors, trade unions, academics and leaders from the third sector and the public sector regarding the best corporation tax regime for Scotland. This feedback will inform the corporation tax system the Scottish Government will introduce.

#### **Benefits from the Proposition**

As highlighted above, corporation tax is one of the chief levers that any government can use to promote growth, investment and jobs over the long run. Control over this lever will provide the Scottish Government with a powerful new policy lever to promote growth and jobs.

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<sup>11</sup> Scotland Bill Committee Report Col. 59 - <http://www.scottish.parliament.uk/s3/committees/scotBill/reports-11/sbr11-01.htm>

Devolution of corporation tax would also increase the financial responsibility of the Scottish Government by increasing the link between the taxation raised by the Scottish Government and the Scottish Government's public spending programme. At the moment, currently 90% of Scottish tax revenues flow to Westminster – a balance that must be addressed.

Initial modelling results by the Scottish Government – using a detailed macroeconomic model of the Scottish economy – highlight the impact that devolving corporation tax could have on Scotland's economy over the long-term.

## Box 2: Initial Modelling Results from Reducing Corporation Tax in Scotland

The Scottish Government has undertaken initial modelling work to explore how changes to the corporation tax rate could impact the Scottish economy. Using a Computable General Equilibrium (CGE) of the Scottish economy<sup>12</sup>, the impact from reducing corporation tax is captured through the following different channels:

- Increasing investment of existing firms in Scotland as a result of reducing the amount of tax paid on profits and capital expenditure;
- Increasing foreign direct investment as Scotland becomes a more attractive place to relocate, which will boost Scottish exports; and
- Adjusting the Scottish Government's budget to changes in total tax receipts.

The initial modelling work focuses on pre-announcing a reduction in corporation tax in Scotland equivalent to a fall from 23% to 20% (i.e. 3% points below the rate planned to be introduced by the UK Government in 2014-15) under a balanced budget scenario. This captures the impact on all tax revenues in Scotland. Under these assumptions, the long-term results from the initial modelling work indicates the following potential economic impact:

- An increase in the level of Scottish GDP by 1.4% after 20 years;
- Overall employment in Scotland will increase by 1.1% (equivalent to around 27,000 jobs) after 20 years;
- An increase in overall investment in the Scottish economy by 1.9% after 20 years; and

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<sup>12</sup> The Model has been developed at the University of Strathclyde and has been applied extensively in policy simulations over the last 20 Years. Background information on the model can be found in the following paper: Harrigan F., McGregor P.G., Dourmashkin N., R. Permann, Swales K. and Yin Y.P., (1991), AMOS: A macro-micro model of Scotland. *Economic Modelling*, Vol. 8, No. 4, 424-79. The variant of the Model used in these simulations has been developed by Patrizio Lecca, Peter G McGregor and J. Kim Swales. Technical assistance has been provided by the above authors but the analysis has been taken forward by the Scottish Government.

- A boost to Scottish exports to the rest of the UK by 1.4% and to the rest of the world by 1.3% after 20 years.

Further modelling highlights that the optimum way to do this is to pre-announce the reduction to occur a number of years prior to implementation.

These results should be viewed as initial estimates. For example, there are additional potential benefits which would arise from a reduction in corporation tax that are not captured in these initial results. For example, any productivity enhancements from attracting more high-value firms to Scotland is currently not incorporated.

The Scottish Government will undertake further work in the coming weeks to model these effects and investigate different policy options for reducing corporation tax in Scotland. The results from this work will be published in due course.

## **Implementation Issues**

### Tax Administration

Following agreement to devolve corporation tax within the Scotland Bill, there are two potential options to administer the new system. The Scottish Government could contract HMRC to administer and enforce a Scottish corporation tax regime; or alternatively we could establish a Scottish tax collection agency, reflecting our ambition for greater fiscal autonomy.

We will look for any tax collection system to fulfil a number of specific criteria, including:

- Minimising the burden on taxpayers (personal and corporate);
- Simplifying the tax systems, in consultation with taxpayers, over the medium term; and
- Ensuring that the overall burden on businesses does not place them at a disadvantage to our key competitors.

There are numerous examples where corporation tax has been successfully devolved in other countries and they all continue to perform effectively and competitively. Furthermore, there are examples where systems have been developed to minimise costs of administration. For example, corporation tax revenues in the USA are allocated to state governments using various measures of economic activity such as sales revenues. Companies operating in both the Basque Country and the rest of Spain are liable to

corporation tax in both jurisdictions. However arrangements exist so that the smallest companies only pay corporation tax to one or other jurisdiction.

Therefore the Scottish Government believes that there is no reason why Scotland cannot follow the lead of other countries by introducing an efficient and effective system for collecting corporation tax receipts in Scotland.

### State Aid

Within the context of the Scotland Bill, it is important that any tax varying power satisfies EU rules and regulations. In recent years a number of cases have been brought before the Courts concerning the ability of governments *within* Member States to set business tax rates which are different to those set for the Member State as a whole. Recent cases have concerned the corporation tax measures introduced in the Azores, Basque Country and Gibraltar.

In delivering judgement on the Azores case, the European Court of Justice (ECJ) ruled that to justify a different tax rate on businesses at an intra-Member State level the region/country must satisfy three conditions of autonomy; constitutional, procedural and financial. Institutional autonomy requires that the sub-central government has a political and administrative structure distinct from the centre. To comply with procedural autonomy, any decision by the sub-centre to change taxation must be taken without central interference. Finally to satisfy financial autonomy, the fiscal consequences flowing from a reduction in the tax rate must not be offset by aid or subsidies from the central government.

Within the Scotland Bill, full devolution of corporation tax – including responsibility for the tax rate, base and financial implications in Scotland of changes to corporation tax policy – would be consistent with the Azores Case.

Indeed, based on their own assessment of the conditions, HM Treasury concludes that devolving corporation tax to Northern Ireland would meet the Azores criteria<sup>13</sup>.

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<sup>13</sup> [http://www.hm-treasury.gov.uk/consult\\_rebalancing\\_ni\\_economy.htm](http://www.hm-treasury.gov.uk/consult_rebalancing_ni_economy.htm)

## Profit Shifting

Concern has been raised previously by some commentators over the potential for a different corporation tax regime in Scotland resulting in profit shifting (or “brass plating”) from the UK whereby profits but not the economic activity shifts to Scotland.

The Scottish Government is committed to establishing a fair and transparent corporate tax system which attracts and retains genuine economic activity and will work with the UK Government to minimise any profit shifting. In practice, significant institutional and accounting rules already exist both within the UK and internationally to ensure that profit shifting does not happen.

It would therefore be about *managing* the implementation of a different tax regime rather than any fundamental change to the tax system. It would not be necessary to create an entirely new system, but instead ensure the efficient operation of current rules and procedures.

The cross-party House of Commons Northern Ireland Affairs Committee, when discussing this issue in the context of Northern Ireland, recognised the issue of brass plating but concluded that the evidence suggests that this risk is sufficiently well mitigated against for it not to present a persuasive argument<sup>14</sup>. The Scottish Government shares this view.

## Financial Implications

There has been some debate over the impact to the Scottish Government’s budget of a cut to the corporation tax rate.

HMRC have estimated, without the request of the Scottish Government, their estimate of the potential impact of reducing the corporation tax rate in Scotland to 12.5%. This analysis estimated that such a move would lead to a funding gap in the Scottish Government’s budget of more than £2.6bn<sup>15</sup>. This figure clearly exaggerates the impact – particularly as current corporation tax receipts in Scotland are just under £2.6bn in 2009-10.

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<sup>14</sup> “Corporation Tax in Northern Ireland: First Report of Session 2010 – 12”, House of Commons Northern Ireland Affairs Committee, May 2011.

<sup>15</sup> [www.scotlandoffice.gov.uk/scotlandoffice/15622.html](http://www.scotlandoffice.gov.uk/scotlandoffice/15622.html)

Not only does the Scottish Government have major concerns over the methodology adopted by HMRC to produce this estimate<sup>16</sup> - particularly over the failure of the analysis to include any of the positive effects on the economy from a reduction in corporation tax - a fundamental problem with the analysis is that it considers the cost to the UK Exchequer rather than the financial implications for the Scottish Government.

Our proposition – set out above – requests that corporation tax be fully devolved to the Scottish Parliament. We are not asking the UK Government to set a lower corporation tax rate on our behalf.

Devolving corporation tax to Scotland will mean that the UK Government will forgo corporation tax revenue collected in Scotland (which is estimated to be £2.6bn in 2009-10). However, it will also lead to an immediate adjustment to the Scottish Government's block grant by the equivalent amount, therefore the net effect to the UK Exchequer would be zero. It will then be for the Scottish Parliament to decide on the appropriate tax structure for Scotland, and to bear the full financial consequences of any decision it takes.

As with any policy choice, a balance will be struck between setting a competitive corporation tax system which supports economic activity, and funding the delivery of world class public services. A lower corporation tax rate can stimulate economic activity, thereby increasing the tax base and thus acting to increase revenues. This was the case in the modelling work undertaken by the Economic Advisory Group of the Northern Ireland Executive<sup>17</sup>. The effects can be particularly pronounced for small countries where attracting higher levels of investment can have a particularly large impact.

It is also the case for the UK, where despite the planned reduction in the headline corporation tax rate in the UK to 23% by 2014-15, the latest forecasts by the Office for Budget Responsibility predict that total on-shore receipts in 2013-14 will be higher than their pre-recession peak<sup>18</sup>.

The Scottish Government would take a responsible approach to corporation tax – like our current tax varying powers in Non-Domestic Rates and (in partnership with local authorities)

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<sup>16</sup> See Box 2 on page 43 of the "Corporation Tax: Discussion Paper Options for Reform", Scottish Government 16<sup>th</sup> August 2011 <http://www.scotland.gov.uk/Publications/2011/08/corporation-tax-paper>

<sup>17</sup> The report estimates that net corporation tax receipts are negative when the corporation tax rate is 12.5% (compared to the base case where the corporation tax rate remains unchanged) up until 2035. However, when all taxes are included the break-even point is in 2021 and if only income tax, national insurance and business rates are included then the break-even point is in 2023. <http://www.eagni.com/fs/doc/publications/impact-of-corporation-tax-on-ni-eag-report-final-report.pdf>

<sup>18</sup> Economic and Fiscal Outlook, March 2011, Office for Budget Responsibility

Council Tax – to ensure that it supports sustainable growth alongside raising a fair and efficient amount of revenue.

## **Conclusion**

The Scottish Government is boosting Scotland's rate of sustainable economic growth. Corporation tax would provide a significant new lever to help deliver this ambition, and there is a compelling case for Scotland securing this power.

Given that the UK Government is currently considering reducing corporation tax below the UK rate in Northern Ireland, there is a strong cross-party view that any discussions over devolving corporation tax should involve all the devolved nations.

The Scotland Bill provides an ideal opportunity to devolve this power.

**Scottish Government**  
**September 2011**

## **ANNEX A: Illustrative Amendment to the Scotland Bill**

After section 36 of the Scotland Bill insert—

### **“36A Scottish corporation tax**

- (1) In Part 4A of the 1998 Act (as inserted by section 28), after Chapter 4 (inserted by section 35) insert—

#### **“CHAPTER 5**

##### **SCOTTISH CORPORATION TAX**

### **80L Scottish corporation tax**

- (1) A tax charged on the profits of companies is a devolved tax.
- (2) “Companies” means bodies corporate or unincorporated associations, but does not include partnerships, local authorities or local authority associations.”
- (2) A tax may not be charged in accordance with the provisions inserted by this section on profits made unless section 36B has effect.

### **36B Disapplication of corporation tax**

- (1) The Corporation Tax Act 2009 (c.4) is amended as follows.
- (2) In section 1328(1) (extent), omit “, Scotland”.
- (3) [Further provisions amending the legislation on corporation tax so that it doesn’t apply in Scotland].
- (4) This section has effect in relation to profits made on or after such date as is appointed by the Treasury, with the consent of the Scottish Parliament, under this subsection.
- (5) For the purposes of subsection (4)—
  - (a) reference to the consent of the Scottish Parliament means consent by resolution, and
  - (b) standing orders must provide that only a member of the Scottish Government may move a motion for such a resolution.”