



**Response from ICAS to the
'Independent Commission for Competitive and
Fair Taxation in Scotland' consultation**

31 July 2015

Introduction

The Institute of Chartered Accountants of Scotland (ICAS) welcomes the opportunity to contribute to the call for evidence from the Independent Commission for Competitive and Fair Taxation in Scotland, issued in June 2015.

Our evidence is restricted to ICAS areas of specific expertise, covering the operational design and administration of taxation arrangements plus commentary on public service reform and aspects of borrowing powers.

About ICAS

ICAS is the first professional body of accountants. We represent over 20,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK and in almost 100 countries around the world. Nearly two thirds of our members work in business or the not for profit sectors, while a third work in accountancy practices.

ICAS has a public interest remit, a duty to act not solely for its members but for the wider benefit. Our evidence aims to inform in a constructive manner and is apolitical.

As part of our response to the call for evidence we have included within appendices the following additional information:

- Appendix 1: The ICAS response to the Commission on Local Tax Reform on its inquiry on local taxation in Scotland (25 June 2015)
- Appendix 2: The ICAS response to the Commission on the Future Delivery of Public Services (the Christie Commission) call for evidence (7 March 2011)
- Appendix 3: An ICAS paper on VAT and the Public Sector (12 December 2014) which has been shared with HM Treasury and HMRC

Our responses on the general questions and specific questions from the call for evidence are set out below.

General questions

Question 1

In your opinion, what are the three most significant public policy challenges facing Scotland at the moment?

Response

We believe that the three most significant public policy challenges are:

- Sustainable economic growth;
- Public service reform; and
- The development of a Scottish fiscal framework.

Sustainable economic growth

A thriving economy is the corner stone which generates the jobs and wealth prioritised in Scotland's national objectives as well as the revenues to invest in public services. This needs to include supporting the early and start-up stage of businesses which add new jobs to the economy.

Public service reform

A step change is needed to quicken the pace and effectiveness of reform to meet the challenges of high quality public services, the impact of an ageing population and projected funding constraints. This will need clear leadership to deliver strategic, not just piecemeal reform. Greater dissemination of good practice, evaluations and examples of reforms which have worked as well as use of benchmarking to identify improvement areas would be helpful to stimulate further change.

The development of a Scottish fiscal framework

The design and implementation of a Scottish fiscal framework is fundamental to the devolution of further powers to Scotland, both in terms of how those powers are exercised and the redefinition of the boundaries of accountability between the Scottish and UK Governments. The manner in which the fiscal framework is agreed, put in place, and its interaction with the overall UK fiscal framework is key to how further devolution is likely to work in practice.

As Lord Smith noted in his report, a challenge facing both the UK and Scottish Parliaments is the relatively weak understanding among members of the public of the current devolution settlement. There is a public policy challenge in ensuring that members of the public understand the constitutional arrangements, are broadly content with them, and their funding by taxation.

In terms of the public's understanding of taxation, the phrases "Scottish taxes" or "devolved taxes" tend to encompass different types of devolution and varying amounts of responsibilities, and can lack precision. A conundrum associated with the levying of tax is that policy makers will seek to raise as much as possible but without drawing undue attention to this, in colloquial terms, plucking the goose with as little hissing as possible. This, however, does not necessarily lead to transparency for those paying the tax, or a sense of responsibility and pride in contributing to the public purse, nor does it necessarily lead to a sense of accountability between those paying and spending. A clear and transparent message to taxpayers and citizens is required.

The nature of the powers over income tax is fundamentally different from those devolved with, for example, Land and Buildings Transaction Tax. There is great scope for confusion; hence fairness and transparency may take time in being achieved for the wider public.

Question 2

Will the taxation, spending and borrowing powers to be devolved to Scotland post-Smith provide a substantial degree of flexibility to enable Scotland to pursue a different public policy agenda compared to the rest of the UK?

Response

Scotland already has a number of policies that are significantly different from the rest of the UK. However, there should perhaps be caution about the extent to which Scotland will be able to pursue increasingly different policies from the UK post-Smith. This is because the funding of policies comes from taxation and to a lesser extent from borrowing, and there needs to be recognition that the different components in the UK fiscal framework are intricately intertwined. This will remain the case when the 'Smith' powers are devolved because income tax, which will be the main source of 'Scottish taxation', will be a partially devolved tax involving joint responsibilities. Political responsibility will be split between the UK and Scottish Parliaments, with the UK Parliament responsible for the tax base (what is considered to be income, and how it is measured) and the Scottish Parliament responsible for the rates and the bands (how much is assessed for collection). It may not be easy to obtain a substantial degree of flexibility from partially devolved income tax powers to set rates and bands.

Question 3

Should the overall burden of taxation in Scotland be lower/higher/the same as in other parts of the UK?

Response

No comment.

Question 4

Is tax competition between different parts of the United Kingdom to be welcomed or avoided?

Response

A tax system works on a number of complex and interrelated principles and interactions. The success of Scotland's tax system depends on it being an integrated and coherent part of the country's wider economic, legal and constitutional package. Tax competition is one element that can be used to attract investment and encourage certain behaviours. However, there can be downsides to tax competition such as:

- If a tax is devolved to Scotland but its tax base is not clear cut then this can create significant new complexities and administrative burdens. For example, many companies operate across the UK and it may not always be easy to isolate profits from different jurisdictions. Consequently, the devolution of a relatively mobile tax such as corporation tax could lead to disputes between taxpayers and the tax authorities about the correct taxing jurisdiction, transfer pricing, double tax relief etc. Different corporation tax rates between Scotland and other parts of the UK would lead to the same issues that currently exist with international tax and its payment to the appropriate authorities.
- Tax competition is usually effected by reducing rates or offering attractive reliefs from tax but this can encourage a damaging "race to the bottom" between different jurisdictions which would reduce tax receipts for both the Scottish and UK Governments.
- Tax competition can also lead to tax avoidance and tax planning. For example, tax can be more competitive in one jurisdiction compared to another in order to attract inward investment or the use of, say, a particular airport. The attraction to the potential taxpayer is a reduction in their tax bill, but it also encourages that taxpayer to avoid a less competitive tax. Equally, tax competition can be between different taxes. For instance, if corporation taxes are lowered there is an incentive for any unincorporated business to seek to convert sources liable to income tax into profits that are liable to corporation tax. In the eyes of some, this is also tax avoidance.

The impact of tax competition can be seen as has already happened for example when Stamp Duty Land Tax (SDLT) structure and rates were changed in December 2014 and Land and Buildings Transactions Tax (LBTT) rates subsequently changed. This resulted in:

- Less tax being raised at a UK level;
- A lower block grant adjustment;
- Greater differences in tax outcomes; leading to a debate on whether a particular outcome is tax competition or might be a part of the 'no detriment' analysis; and
- Behavioural impacts by taxpayers, for example, a lower level of sales in the upper end of the property market and possibly more activity at the lower end of the property market.

Tax competition can also become tied up with 'no detriment' debates if the competition in one part of the UK turns out to be detrimental to another part. At the heart of the 'no detriment' principle is the notion that the impact of policy decisions taken in one part of the UK do not impact adversely on the funding of public services in another part. 'No detriment' will inevitably involve adjustments to the funding Scotland receives each year from the central UK pot.

Question 5

Should the public spending model in Scotland be different to that in other parts of the UK?

Response

In our response to question 2 we refer to the challenges for pursuing different policies with regard to tax raising and borrowing. We also give examples of barriers to public service reform in our responses to the questions on expenditure and borrowing powers. These other responses include the example of revenue borrowing to fund preventative spend as a barrier. In this instance we are seeking a more level playing field in terms of borrowing powers for the Scottish Government relative to the UK Government.

Specific questions

Devolved revenues

Local Taxation

Question 6

Should a larger or smaller share of total revenue collected in Scotland be collected through local taxation?

Question 7

Does the Scottish system of local taxation as a whole need to be reformed? If so, how?

Question 8

If you think the Council Tax should be replaced by a different form of local taxation, what principles would you adopt in devising a new system?

Question 9

If you think that Council Tax needs only to be reformed (rather than replaced), what reforms would you like to see (including anything from reform of bands and limits, or absence of limits, to local discretion as to structure, reliefs or levels of council tax)?

Question 10

Should the system of Business Rates be replaced by a different form of taxation? If so, what principles should underpin a new system?

Question 11

If you think that Business Rates system needs only to be reformed (rather than replaced) what reforms would you like to see (from limits or absence of limits, to local discretion as to structure, reliefs or levels of Business Rates)?

Responses to questions 6 to 11

We have attached our full response to the Commission on Local Tax Reform in Appendix 1 for your information.

We have not identified a preferred option but suggested some principles to support an analysis of possible options in paragraph 18 of this other response for your information.

Some of the key messages from our response include:

- Support for an evidence-based approach to policy development and encouraging the development of balanced, independent research to inform decision-making.
- Emphasis that the reform of local taxation should not be undertaken in isolation but form part of the wider topic of local government funding and devolution of powers.
- At present, the financial position of councils is challenging yet there is currently a high collection rate of local taxation. The timing and nature of reform will need to consider that, at present, the system is likely to have less capacity to absorb financial shocks.
- The potential to improve performance reporting of local authorities, especially financial reporting. Transparent and easily understandable reports are critical to demonstrate appropriate stewardship of public funds and better inform members' decision making. Existing arrangements drive unnecessary layers of complexity and specialism. This reduces the ability of wider stakeholders to hold local authorities to account and assess how well resources are used and indeed how well the authority performs: this is not in the public interest.

Income Tax

Question 12

Do you think that Scotland raises, or will be able to raise, enough/too much/too little of its revenue through Income Tax?

Question 13

Should there be an aim (i) to broaden the tax base, (ii) to increase rates or (iii) to reduce rates, or a combination of all three?

Question 14

Should Income Tax in Scotland mirror the structure and level of Income Tax in the rest of the UK?

Question 15

If not, do you have any suggestions as to the rates, bands or thresholds of Scottish Income Tax?

Response to questions 12 to 15

We are unable to contribute to questions 12 to 15 because, as a matter of policy, ICAS does not comment on the quantum of income tax that may be raised by governments and whether this is sufficient or otherwise, or on whether to broaden the tax base or change the tax rates. These are political choices and for our elected representatives to decide.

Our role is to share insights from ICAS members on the many complex issues and decisions involved in tax system design such as how different taxes may interact with one another, and to highlight operational practicalities.

In relation to question 14, there will always be a balance to be struck between the desire for taxes that are specifically designed for Scottish circumstances and local accountability, and taxes that provide ease of administration for taxpayers, businesses that collect taxes on behalf of the state, and the tax authorities. Ease of administration tends to come from uniformity and certainty.

The cost/benefit analysis for taxpayers is also a key component. It would be possible to reduce or increase income tax – through its base or its rates and bands, or both - but this could come with an operational cost disproportionate to the tax revenue generated. In order to implement such changes there may be costs to taxpayers in areas such as new IT systems, restructuring tax authority staffing, and taxpayer data extraction.

Other Taxes

Question 16

Do you have any comments on the other taxes - Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax - devolved under the Scotland Act 2012?

Response

The taxes that have been devolved to date are those that do not give rise to jurisdictional issues and therefore they have been sensible candidates to be devolved.

Question 17

Do you have any comments on the proposed devolution/assignment of Air Passenger Duty, Aggregates Levy and VAT pursuant to the Bill?

Response

Air Passenger Duty and Aggregates Levy are standalone taxes that do not have significant interaction with other taxes so they lend themselves to being devolved. These taxes will be the political responsibility of the Scottish Parliament and the administrative duties are likely to rest with the new tax authority, Revenue Scotland. The nature of the taxes, the legislation, and the associated collection and management duties are fully devolved and entirely the responsibility of those in Scotland.

VAT remains the responsibility of the EU (in terms of defining the tax base), and the UK Parliament (in setting the tax rates), with administration and collection by HMRC. How accountability to the Scottish Parliament is arrived at through assignment has yet to be decided, and is not determined or directed in the draft tax clauses in the Scotland Bill. Considerable analytical and statistical work will be required if there is to be an amount that can be identified which truly reflects the VAT attributable to Scotland and will in future reflect any changes in the Scottish economy.

The purpose of the assignment of VAT is to align tax income with the economy, but if this is so, it may be that VAT receipts could become a measure of the Scottish economy. This in turn might influence the Scottish Government's economic support programmes with support targeted at areas that would grow the economy (in other words, the VAT take, if this becomes a measure). Such targeting could therefore be at the expense of VAT exempt businesses (such as financial institutions) or zero rated businesses (such as the food industry).

Expenditure**Question 18**

The Christie Commission presented a case for radical public service reform. Do you agree and if so, why?

Response

We have attached our response to the Christie Commission inquiry at Appendix 2.

Question 19

Can you identify specific areas for reform? What would be the potential financial impact of such reform?

Response

Our response to the question focuses on some examples of barriers to public service reform to consider as part of a wider review. These are:

- VAT exemptions;
- State Aid rules; and
- Revenue borrowing powers for preventative spending.

VAT exemptions

The way public services are delivered is evolving. A greater variety of business models exist to help deliver public services more efficiently and effectively. This includes the increasing use of arms-length organisations, subsidiary companies and the third sector to achieve national outcomes. Any decision to outsource service delivery will need to assess the effect of VAT, as other organisations will not necessarily fall within the scope of the VAT shelters which apply to local authorities and the NHS, and compliance with State Aid rules

Inconsistencies in VAT treatment across the public sector can drive complexity and act as an inhibitor to reform. We suggest that consideration needs to be given to levelling the playing field with regards to VAT exemptions. Some organisations, such as local authorities are eligible for VAT relief however the same activity may be undertaken by other types of

organisations which are not VAT exempt. This results in additional VAT costs or creating complex structures to maintain VAT relief which can inhibit innovation and joint working. We suggest that greater consistency in VAT treatment would improve simplification and remove a barrier to public sector reform so that service delivery models are based on meeting public service needs rather than navigating VAT law.

A copy of our detailed paper on 'VAT and the Public Sector' to HM Treasury and HMRC is included at Appendix 3 for your information.

State Aid rules

State Aid rules were created to promote competition and control state subsidy levels so as to maintain a level playing field across Europe. In practice, this means that any government funding such as grants to a small enterprise, the creation of targeted tax reliefs to stimulate economic growth or investing in a framework to facilitate preventative spend¹ would need to be assessed to identify if it would be classed as 'state aid'. Our view is that the objective of economic growth should be prioritised above competition rules, especially given the current economic climate. To simplify the current landscape, the threshold for when these rules apply should exempt SMEs.

ICAS submitted a response to the Commission on the Future Delivery of Public Services (the Christie Commission) in March 2011; the key messages still stand. We note reports from Audit Scotland and the Scottish Parliament² which find that community planning is still a long way from achieving its full potential and notes both the limited impact and slow pace of public sector reform since the Christie Commission was published.

We believe that a more determined and strategic effort is needed to drive forwards reform more urgently. A first step could be to take stock of the Scottish Government's response to the Christie Commission since 2011 and communicate the direction of travel. Updated actions for strategic reform which include identifying and breaking down any existing barriers, wider communication of good practice and what has worked elsewhere and greater scrutiny at a national and local level of progress could help instigate further reform.

Borrowing powers

In our response to question 22 on borrowing powers we discuss the importance of the Scottish Government having the power to fund the revenue aspects of preventative spending. While the UK government has such powers, these have not yet been devolved to the Scottish government. Preventative spending initiatives need working capital and while there are a number of barriers to this, we believe that insufficient borrowing powers is a key one.

Question 20

Can you identify areas of Scottish public expenditure that can and should be reduced?

Question 21

Can you identify areas of Scottish public expenditure that can and should be increased?

Response to questions 20 and 21

Overall reductions in public sector expenditure are required so that the UK can reduce its national debt even if the speed and extent of reductions differ across the different jurisdictions of the UK.

¹ Helping the public sector to develop a framework to change the balance of spend from being reactive (such as treating the elderly in hospital for falls) to preventative (creating a safer home environment to reduce the likelihood of falls in the first place).

² Nov 2014 [Community planning Turning ambition into action](#)

March 2013 [Improving community planning in Scotland](#)
[Reform of Public Services is not delivering - Scottish Parliament 2013](#)

It is a matter for the UK government and for devolved administrations to determine how to allocate scarce resources in accordance with their respective policy priorities. However, we do believe that moving away from crisis spending to preventative spending is desirable. Where preventative spending approaches are successful both individuals and communities benefit and savings can be achieved in the long-term as a consequence of reshaping public services.

Borrowing powers

Question 22

What principles and limits would you apply to borrowing powers, present or future on conclusion of the Smith Agreement negotiations?

Response

We have commented on borrowing powers in written evidence to other inquiries. Our comments have been in the context of our support for a shift from crisis spending towards preventative spending and we have similarly limited our comments here to this aspect of additional borrowing powers. We do not comment on possible borrowing limits as these are a matter for negotiation between the Scottish and UK Governments.

The draft clauses of the Scotland Bill do not cover the devolution of the additional borrowing powers which are referred to in the Smith Agreement and we are not currently aware of any detailed proposals on the extent of these.

In our evidence to the Smith Commission and to the Scottish Parliament's Finance Committee we recommended that the Scottish Government should have additional revenue borrowing powers to fund preventative spending.

We have approached this recommendation from the perspective that additional monies are needed to shift the balance between crisis spending on public services to preventative spending in order to achieve longer term savings.

During this extended period of public spending restraint and increasing demand for public services, we support the development and roll out of arrangements which support a preventative spend agenda to achieve better outcomes for communities over the longer term. However, if transformational change is to take place within our public services, we believe that further revenue borrowing powers than have been articulated so far are needed.

At present Scottish local authorities can borrow to fund capital within the bounds of the Prudential Code and the Scotland Act 2012 gives limited borrowing powers over capital and revenue which will be extended further following the implementation of the Smith Commission Agreement. Neither the Smith Commission report nor HM Government's 'Scotland in the United Kingdom: An enduring settlement' refer to preventative spending in their respective commentaries on borrowing powers. Therefore, in our view, the reports could not be interpreted as permitting revenue borrowing to fund the revenue aspects of preventative spend.

Borrowing for capital projects has always been viewed as preferable to borrowing to fund revenue expenditure on public services due to the benefits accrued from capital expenditure being spread over more than one financial year. A key overarching objective of preventative spending initiatives is to reduce demand for public services and create future savings. Therefore, preventative spending, like capital spending, is about investing in the future. We believe this provides clear justification for the extension of the Scottish Government's revenue borrowing powers to fund preventative spend initiatives within prescribed limits.

Charities are major providers of public services and we believe that there is knowledge and experience within this sector which is vital to the success of preventative spending approaches. While there are a number of barriers to taking forward preventative spend initiatives, some of which could be overcome within the existing devolved arrangements, we believe that further revenue borrowing powers need to be devolved to support a shift away from crisis spend.

The debt financing of charities by government is a potential model for providing working capital to charities for preventative spend initiatives. However, debt financing, where interest is charged below commercial rates, has the potential to be caught by the EU State Aid rules. The State Aid rules were created to promote competition and control state subsidy levels so as to maintain a level playing field across Europe. In practice, this means that government funding such as grants to a small enterprise, the creation of targeted tax reliefs to stimulate economic growth or investing in a framework to facilitate a move towards more preventative spending could be classed as 'State Aid' if certain criteria and tests are met.

We have approached the question on extending borrowing powers from the perspective of removing barriers to preventative spending which in turn has the potential to transform public services, improve lives and make savings.

Preventative spending does not guarantee success and therefore there are risks attached to it. Nevertheless, we believe that it is appropriate for the Scottish Government to be able to borrow to fund the revenue aspects of preventative spend initiatives, within an overall prescribed cash limit, where there is a realistic prospect of achieving savings. The resultant savings could reduce public spending in the long-term or free up resources which could be re-deployed elsewhere in the public services.

In addition to placing an overall cash limit on the amount the Scottish Government can borrow for preventative spending initiatives, we would envisage that borrowings would need to be repaid within a specified period of time and that governance arrangements would include measures to ensure that borrowings could not be used to fund recurrent revenue expenditure.

Borrowing must be affordable, sustainable and prudent and should be shared proportionately with future generations. Therefore, borrowing powers, in the context of the fiscal framework must be structured with these principles in mind whether these are exercised to fund shortfalls in taxation revenue, investment in assets or for preventative spending.

Contact:

If you require further information please contact:

Name	Charlotte Barbour
Organisation (if applicable)	ICAS
Contact details (email/phone/address)	cbarbour@icas.com

We have no objections to the publication of this response.

The Commission on Local Tax Reform
Scottish Parliament

By email to: evidence@localtaxcommission.scot

25 June 2015

Review of local taxation

Introduction

1. ICAS welcomes the subject of this consultation and the opportunity to comment. We are a leading professional body for chartered accountants with over 20,000 members working across the UK and internationally. Our members work across the private and not for profit sectors.
2. ICAS's Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key messages

3. Changing local taxation is a complex and sensitive task. The objectives and timescale of this exercise are challenging and the problems to be grappled with to achieve a workable and fair alternative, significant and multi-dimensional.
4. The financial challenges facing councils and the prospect of increasingly challenging budgets is well-documented. It is therefore important that a review, or any resultant changes, do not affect the relative certainty of the £2 billion¹ of revenue currently generated by the existing council tax arrangements. Moreover, this background needs to be carefully considered as part of a risk and impact assessment as the capacity of the current system to implement change and bear any shocks or associated risks is likely to be more limited.
5. Scotland is in a period of unprecedented change around the devolution of powers, including taxation to Scotland and community empowerment. We believe that a review of local taxation should form part of a more holistic exercise that considers the wider context of strategic change, local government funding and tax to give a clearer perspective of current and projected priorities, needs and challenges.
6. Overall, we suggest that the Commission pursues a more holistic and long term view which takes into account this multi-dimensional and evolving context. A useful step would be for the Commission to take the time to establish a robust and wide ranging evidence base for recommendations on a direction of travel which ensures that there is room in any conclusions to adapt to different circumstances arising from the Smith Commission and other reforms.
7. The statutory powers and purpose of local taxation need to be defined and clear principles articulated to provide a framework for setting direction and assessing options.
8. There is need for, and potential to improve, the transparency and accountability of local authorities in terms of how resources (including council tax) are used and how well the authority performs. There is a complicated landscape of funding, services and responsibilities split

¹ http://www.audit-scotland.gov.uk/docs/local/2015/nr_150305_local_government_overview.pdf page



between central and local government. Tax payers need a clearer picture of what they are paying for. This includes improved clarity on where councils are complying with statutory levels of service and where they exercise discretion.

9. We are concerned that local authority financial statements do not give a clear picture of the true cost of providing services. This is not in the public interest. We recommend that the statutory framework which conflates the council tax calculation and accounting purpose of financial statements is amended to remove this barrier to simpler and more understandable accounts. This would help to increase the transparency of the performance of local government.
10. In terms of options for local taxation, this is an area of judgement and different ideological perspectives, so rather than being able to conclude on an objective basis at this point, we hope the Commission sees its role as investing in the groundwork to enable a more objective assessment to be formed. It would be useful to be informed by international comparisons of what works elsewhere. Any change, regardless of preference, will require robust evidence and modelling of impacts as well as a suitable transition period to minimise the extent of any potential negative consequences for taxpayers, particularly in the current economic climate.

Current arrangements

11. Council tax has a high and increasing collection rate² as well as a low administration cost³. It is easy to understand and has a transparent charging system. It reliably raises around £2 billion (representing 95.2% of total billed in 2014) which demonstrates a level of acceptability by tax payers. However, bandings and valuations are significantly out of date, having not been updated since 1991. Over time, differing levels of property valuations may distort the fairness between bandings. An evaluation would need to assess the impact of this and identify what can be managed by updating the valuations, what can be achieved by incremental reform, what needs radical overhaul, short and long term actions and appropriate timings. A key consideration is to minimise the risk of financial loss for local authorities at a time when they are facing increasing budgetary challenges.
12. Scottish Government figures⁴ show year-on-year above inflation rises in council tax charges, before the freeze from 2008-09. Moreover, these increases were happening at a time when the economy and public finances were in a very different position to where they are now, particularly in the context of further austerity. This has created some adverse publicity for council tax and will need to be considered as part of any reform and communications to taxpayers.
13. Application of above inflation increases is likely to reduce correlation between the level of taxation and ability to pay. It is important to also consider the impact and role of increases over time on affordability and fairness. Modelling the impact of any tax changes is crucial to reduce the negative consequences of significant increases and differences.

Creating the right conditions for reform

14. We note the various reviews and abortive attempts to reform local taxation which underlines the complexity, sensitivity and challenge of achieving a fairer system. At this point in time, council tax in Scotland may also be a less prominent issue in the minds of taxpayers given the council tax freeze since 2007.
15. There is a need to create the right conditions for reform including a communication exercise to help the public understand the background, context and need for reform. Publication of a discussion paper supported by research which collates up to date evidence, key projections, international comparatives and models the impact of alternatives is essential to inform next steps. We would welcome further clarity of the vision for reform and intended outcome of the

² <http://www.gov.scot/Publications/2014/06/3066>

³ <http://www.irrvscotland.org.uk/documents/robin%20haynes.pdf>

⁴ See Annex 2



review. We would also welcome more open communication on government responses to previous reviews, such as [A Fairer Way \(2006\)](#), to inform the debate.

Principles, powers and objectives of local taxation

16. Revenue Scotland has identified 4 [principles of the Scottish approach to tax](#). We ask the Commission to clarify its intentions as to whether these principles for national tax will also be adopted for local taxation or if new principles will be articulated.
17. The [remit of the Commission](#) identifies the objective of a fairer system of local taxation. Further articulation of what the Scottish Government means by 'fairer' would help to base a future assessment of options. Revenue Scotland has identified its fourth principle as 'proportionate to the ability to pay'⁵. The term 'ability to pay' is subjective, so the Commission would need to define what it means by this i.e. whether it would reflect gross income only, disposable income or income less essential expenditure (e.g. number of dependents and taxpayers in a household), capital or a combination of income and capital.
18. In our view the following could support key principles to assess options:
- Proportionate, reflecting ability to pay;
 - Simple to understand and transparent;
 - High collection rates, predictable revenues and difficult to avoid;
 - Clear accountability which connects decision making and spending of public funds with taxes raised;
 - Cost effective to administer;
 - A broad but balanced tax base. This builds on:
 - Making a contribution to the costs of government (which expands on the principle attributed to Adam Smith in paragraph 5(d): "*The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities*"⁶;
 - Supporting broad accountability and voter representation to avoid the negative consequences of focusing on a narrow tax base which can create a more risky dependency for revenue and unhealthy level of influence in a smaller, less representative group;
 - Value for money & best value – "*every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state...*" (Adam Smith⁷). If we expect value for money from expenditure on public services then this principle could be usefully applied to raising revenue to fund those services i.e. a duty to be neither profligate in the spending of public funds nor in the raising of tax revenues;
 - Stable and predictable revenues;
 - Aligned with current, not historic, needs and priorities;
 - A basket of taxes to minimise overloading one form with the risk that it can reduce incentive to pay, as identified by the Laffer Curve⁸.

⁵ Proportionate to the taxpayer's ability to pay: The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities" The Wealth of Nations, Book V Chapter II Pt II, P.825 para 3.

⁶ [The Wealth of Nations, Book V Chapter II Pt II, P.825 para 3 - Adam Smith](#)

⁷ The Wealth of Nations, Book V Chapter II Pt II, p. 826, para. 6

⁸ [Laffer curve and modelling of increase in tax rate on revenue](#)



Accountability and balance of funding

19. One of the intentions of council tax was to provide local authorities with discretion for raising and setting tax and to provide direct accountability with the taxpayer for its spending decisions. A direct link between tax and spend is a part of the system of local democracy. Although evidence of the effectiveness of council tax as a tool to encourage stewardship and discourage profligacy is uncertain, the issue of an invoice by a local authority bearing its decision on council tax increases is a clear message which can and does trigger comment.
20. A local tax is only one part of a wider framework of accountability and engagement which has evolved significantly since 1990. The complexity of local authorities, variety of accountability mechanisms and range of public performance reporting can make it difficult for taxpayers to get a holistic picture of their performance and financial stewardship.
21. The structure of funding, control and therefore accountability over local public services is complicated. It is not clear exactly what services the council tax is directly paying for and where councils are exercising their discretion as opposed to acting as an agent of central government or implementing centrally set statutory requirements. There are various examples:
 - Education is provided locally but the strategy and curriculum is set centrally;
 - The ability of local authorities to set fees is variable. For example, licensing and planning fees are based on legislation so local authorities do not have the same level of discretion, they may have for swimming pool charges (although they must still operate within certain parameters which restrict the ability to make a profit);
 - Council tax funds less than 20% of local services with central government providing the majority of funding (in turn allocated through tax collected by the UK government).
22. The result is that it is not sufficiently clear to the public what decisions on local services are made by the local authority alone and which are driven nationally. Effective accountability needs to be able to link responsibilities and decision making powers with performance. Taxpayers need a clearer picture of what they are paying for. This should include local authorities being transparent about where they are complying with statutory levels and where they are exercising discretion.
23. Effective accountability needs to include financial performance as well as the longer term financial position, borrowing and alternative financing of capital expenditure. One of the principal publications which is used to understand any organisation, its objectives, performance and stewardship of funds is its' annual report and accounts. Public performance reporting may be varied for local authorities yet the regulatory framework is still quite light touch so there is not a consistent approach and it can be difficult for taxpayers to get a succinct, holistic picture of performance. Local authorities have no statutory requirement to produce an annual report (although some may do so on a voluntary basis) so a crucial document to show how well they have spent public funds and met their responsibilities is the financial statements.
24. ICAS is concerned that the financial statements of local authorities do not communicate the true cost of providing services clearly enough for a public audience. The statutory framework which governs the council tax calculation has created a conflict with accounting practice which is managed by a series of material adjustments in the accounts. This has created specialism and complexity in local authority accounts which obfuscates the true financial position of the local authority. It creates a significant barrier to transparency and simplification of the published financial statements and considerably weakens the ability of the taxpayer to hold their authority to account for financial performance. This is not in the public interest. It is important to fully support and publicly justify decisions to increase council tax, particularly in the context of year on year above inflation increases as shown in Annex 2.
25. The root cause of much of the accounting specialisms is the [Local Government Finance Act 1992](#) (Section 93) which combines the purpose of accounts with the council tax calculation (and housing rent setting). We would encourage the legislation to be updated to remove the dual purpose of local authority accounts. Further explanation is provided in Annex 1.



26. The declining proportion of council tax as a contribution to local authority funding (currently around 20%) means that it has become increasingly marginal so it becomes more difficult to relate to locally controlled areas. It is unlikely to be perceived as fair by taxpayers if local authorities were to increase local taxes to fill spending gaps which may be beyond their control or to express discontent with central policies. This is one reason why reform of council tax should not be undertaken in isolation from the wider issue of local government funding, a strategy for addressing financial challenges and the interaction with central government.
27. There is a trend for both centralisation and localism as exemplified by reorganisation of local authority services including the introduction of national fire and police services which were previously 49% funded by local authorities. There is also greater focus on community engagement e.g. The Community Empowerment Bill as well as increasing the devolution of powers at jurisdiction level. This suggests we are in a period of some fluctuation, so consideration of the impact of these changes at a local level and communication of the vision for service delivery across central and local government would be an area to consider as part of this review.
28. The proportion of council tax funding for local authorities is also affected by policy changes. As an example, around 40% of local government expenditure relates to social services and education, so any changes to how these major services are organised would have a significant impact on the proportion of council tax as part of local government funding.
29. In Scotland, water is billed by local authorities on the same invoice as council tax, on behalf of Scottish Water. Scottish Water also pays the local authority a fee for debt collection. This may offer convenience and efficiency for water billing and collection, however, it risks obscuring the accountability of Scottish Water and creating confusion for some customers as to whether water is a separate charge, unrelated to council tax.
30. We suggest that the impact of this arrangement on accountability should be reviewed. We also suggest greater transparency of the costs and income received by local authorities for this arrangement and further clarification of any differences between commercial and householder contributors.

A more holistic exercise

31. Our understanding is that the remit of the Commission's review of local taxation has been tightly drawn around council tax. We are not convinced that effective reform of council tax can be achieved by looking at one element of local government finance in isolation.
32. There is a wider context which deserves consideration as part of a holistic exercise. Any changes to the current system of local taxation should reflect current needs and support wider developments. This includes:
- Local authority funding challenges, performance and accountability;
 - The package and implications of devolution of tax powers to the Scottish Parliament;
 - The impacts of the Welfare Reform Act 2012, which are not yet known;
 - The effect of a sustained period of house price inflation on affordability levels and perceptions of wealth taxes (a concept which is not currently part of the UK fiscal framework);
 - The changing policy context around centralisation and localisation of services as well as the development of community empowerment;
 - Changing household profiles;
 - The growth of an ageing population;
 - Current strategic priorities, needs and how well or otherwise, the existing council tax system, its exemptions and discounts aligns with these.



33. An example of strategic priorities could include assessing how well discounts help drive efficient use of housing stock to support the Scottish Government's Housing Strategy⁹. There are also findings from the Land Reform Group¹⁰ which raise the question of how well aligned historic exemptions for land based businesses are with current day needs and priorities, which has implications for local government funding.

Options and alternatives

34. ICAS does not have a view on a preferred option although we recognise various alternatives for local taxation exist. We suggest that the Commission seeks to identify options which have been applied successfully in different international jurisdictions and assess if these could apply in Scotland. If, after this initial consultation exercise, the Commission decides which options it will explore further, we would be pleased to offer our comments. Some of our initial comments include:

- The need for and extent of reform needs to be evidenced, articulated and assessed against the areas council tax performs well, along with implementation risks;
- Council tax to date suggests that the concept of a property base for the tax is supported by taxpayers and this forms part of the existing basket of taxes;
- A structure is now in place for the new Scottish Rate of Income Tax, administered by HMRC. Any further variables introduced through a local based income tax, which could potentially create up to 32 more variables, would add cost and administrative complexity (identification of the residence of the local tax payer adding a further layer);
- Council tax is based on valuations as a proxy. It is not a wealth tax as it is paid by occupiers, not just owners. It is also a hybrid of different tax concepts e.g. consumer based reductions for second homes/ single occupancy and income based for council tax reductions. The Commission needs to identify its purpose for a reformed local tax;
- A tax based purely on valuation would essentially be a wealth tax as it taxes unrealised gains, not cash income. This would therefore be a new concept in the UK fiscal framework. There are likely to be differing views on how fair and affordable a wealth tax based on sales valuations would be, especially after an extended period of house price inflation. A tax based directly on a percentage of current valuation is likely to pose affordability issues for those who have lived in the same property for many years and would not necessarily be able to afford to purchase the same property at the current market price. The selection of a multiple for the bands which meets affordability needs and transition is crucial;
- Reform will most likely need to be incremental (this will obviously be dependent on how radical the option chosen by Ministers is) and communicated well to stabilise transition and gain public support;
- Equitable redistribution – a mechanism to support areas with lower tax bases (capacity) by those with higher tax bases already exists through the formula-based central grant allocation. Any changes in local taxation would need to include this as part of an impact assessment.

35. We hope this is helpful and please do not hesitate to get in touch if we can be of further assistance.

Yours sincerely,

Alice Telfer
Assistant Director Business Policy and Public Sector
ICAS

⁹ [The Scottish Government's Strategy and Action Plan for Housing in the Next Decade: 2011-2020](#) (pg 2-4)

¹⁰ [Report of the Land Reform Review Group 2014 - The Land of Scotland and the Common Good \(pg 169\)](#)



ANNEX 1

Complexity of financial reporting

Local authority financial statements are specialist, complex and therefore difficult to understand. This is driven by legal requirements on council tax funding which conflict with the legal requirements to observe proper accounting practice. This does not support financial transparency and accountability.

The root cause of much of the accounting specialisms in local authority accounts is the Local Government Finance Act 1992 (Section 93) which requires local authorities when setting a budget to take into account *"any means by which those expenses may otherwise be met or provided for"* (paragraph 4). This includes 'reserves brought forward'. As a result the accounts contain both the IFRS-compliant numbers and the carried forward Reserves balance which is required under statute to be taken into account for the council tax calculation (and housing rent setting). This carried forward balance used in the council tax calculation is known as the General Fund.

Various statutory adjustments are made to the figures appearing in the IFRS accounts to transfer components to an Unusable Reserves balance to leave the identifiable General Fund. This dual purpose means that certain costs which one would expect to see in an Income and Expenditure Account such as depreciation and certain anticipated pensions costs, are removed using a series of statutory accounting adjustments so that they do not affect the bottom line, which is used to show the council tax funding requirement. The adjustments are recorded in the reserves statement and referred to as "adjustments between the accounting and funding basis".

These adjustments have accumulated over time. Currently around 18 statutory adjustments^[1] are available for local authorities to apply. These arise from items which do not have an immediate cash flow implication, to mitigate the impact on the setting of the council tax. Across councils the most common adjustments, and the most material, tend to relate to differences in the accounting for pension costs, depreciation charges, capital grants and capital charges. The adjustments are carried in the balance sheet under the heading "Unusable Reserves". In many instances the balance on this account is a material component of the balance sheet.

^[1] CIPFA Code 2015-16 Statutory Mitigation Disclosures para 3.4.2.40 (page 67)



Council tax increases year on year

BAND D COUNCIL TAX 1996-97 TO 2015-16																				
	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	Council Tax Freeze							
	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Scotland	708	10%	5%	3%	4%	5%	4%	4%	4%	4%	3%	2%	1,149	1,149	1,149	1,149	1,149	1,149	1,149	1,149
Aberdeen City	648	9%	10%	4%	6%	6%	5%	4%	8%	5%	3%	2%	1,230	1,230	1,230	1,230	1,230	1,230	1,230	1,230
Aberdeenshire	591	8%	7%	3%	7%	9%	7%	5%	5%	4%	2%	1,141	1,141	1,141	1,141	1,141	1,141	1,141	1,141	1,141
Angus	659	3%	4%	3%	5%	6%	7%	6%	5%	5%	3%	0%	1,072	1,072	1,072	1,072	1,072	1,072	1,072	1,072
Argyll & Bute	675	16%	9%	0%	6%	5%	2%	2%	4%	4%	3%	2%	1,178	1,178	1,178	1,178	1,178	1,178	1,178	1,178
Clackmannanshire	692	8%	9%	5%	4%	4%	3%	2%	5%	3%	5%	2%	1,148	1,148	1,148	1,148	1,148	1,148	1,148	1,148
Dumfries & Galloway	590	17%	2%	5%	6%	5%	5%	3%	3%	2%	3%	3%	1,049	1,049	1,049	1,049	1,049	1,049	1,049	1,049
Dundee City	801	13%	7%	4%	2%	-1%	3%	1%	4%	4%	3%	0%	1,211	1,211	1,211	1,211	1,211	1,211	1,211	1,211
East Ayrshire	714	8%	5%	3%	3%	5%	5%	5%	5%	5%	5%	2%	1,189	1,189	1,189	1,189	1,189	1,189	1,189	1,189
East Dunbartonshire	668	13%	2%	5%	0%	5%	5%	5%	6%	4%	4%	2%	1,142	1,142	1,142	1,142	1,142	1,142	1,142	1,142
East Lothian	670	7%	5%	4%	8%	6%	5%	4%	5%	2%	2%	2%	1,118	1,118	1,118	1,118	1,118	1,118	1,118	1,118
East Renfrewshire	621	9%	6%	5%	6%	6%	6%	5%	5%	5%	5%	2%	1,126	1,126	1,126	1,126	1,126	1,126	1,126	1,126
Edinburgh, City of	812	3%	3%	2%	3%	5%	4%	4%	4%	4%	2%	1%	1,169	1,169	1,169	1,169	1,169	1,169	1,169	1,169
Eilean Siar	550	8%	9%	5%	5%	5%	6%	6%	5%	5%	4%	2%	1,024	1,024	1,024	1,024	1,024	1,024	1,024	1,024
Falkirk	624	8%	3%	3%	5%	7%	6%	5%	5%	5%	4%	2%	1,070	1,070	1,070	1,070	1,070	1,070	1,070	1,070
Fife	694	7%	3%	5%	5%	5%	5%	5%	5%	3%	3%	4%	1,118	1,118	1,118	1,118	1,118	1,118	1,118	1,118
Glasgow City	805	18%	9%	0%	2%	2%	2%	2%	2%	2%	0%	0%	1,213	1,213	1,213	1,213	1,213	1,213	1,213	1,213
Highland	659	8%	7%	3%	5%	6%	5%	5%	5%	4%	4%	2%	1,163	1,163	1,163	1,163	1,163	1,163	1,163	1,163
Inverclyde	762	8%	4%	3%	5%	8%	5%	2%	5%	3%	2%	-1%	1,198	1,198	1,198	1,198	1,198	1,198	1,198	1,198
Midlothian	718	16%	4%	5%	3%	4%	3%	3%	5%	4%	3%	0%	1,210	1,210	1,210	1,210	1,210	1,210	1,210	1,210
Moray	608	7%	7%	3%	8%	5%	5%	5%	9%	5%	5%	3%	1,135	1,135	1,135	1,135	1,135	1,135	1,135	1,135
North Ayrshire	660	8%	4%	5%	5%	6%	5%	5%	5%	5%	4%	2%	1,152	1,152	1,152	1,152	1,152	1,152	1,152	1,152
North Lanarkshire	758	4%	3%	4%	4%	3%	3%	3%	3%	3%	3%	2%	1,098	1,098	1,098	1,098	1,098	1,098	1,098	1,098
Orkney Islands	480	7%	13%	5%	10%	8%	8%	8%	4%	3%	3%	3%	1,037	1,037	1,037	1,037	1,037	1,037	1,037	1,037
Perth & Kinross	699	5%	0%	3%	5%	9%	7%	5%	5%	5%	4%	2%	1,158	1,158	1,158	1,158	1,158	1,158	1,158	1,158
Renfrewshire	738	6%	0%	0%	7%	6%	5%	5%	5%	5%	5%	2%	1,165	1,165	1,165	1,165	1,165	1,165	1,165	1,165
Scottish Borders	558	9%	4%	5%	8%	8%	8%	8%	5%	3%	4%	2%	1,084	1,084	1,084	1,084	1,084	1,084	1,084	1,084
Shetland Islands	443	9%	13%	10%	9%	8%	8%	7%	7%	5%	4%	3%	1,053	1,053	1,053	1,053	1,053	1,053	1,053	1,053
South Ayrshire	731	4%	3%	0%	5%	5%	5%	5%	5%	5%	4%	4%	1,154	1,154	1,154	1,154	1,154	1,154	1,154	1,154
South Lanarkshire	724	9%	8%	2%	2%	2%	2%	2%	3%	3%	3%	2%	1,101	1,101	1,101	1,101	1,101	1,101	1,101	1,101
Stirling	678	17%	1%	5%	9%	6%	6%	5%	4%	4%	4%	2%	1,209	1,209	1,209	1,209	1,197	1,197	1,197	1,197
West Dunbartonshire	812	13%	3%	-3%	2%	2%	2%	2%	2%	2%	2%	2%	1,163	1,163	1,163	1,163	1,163	1,163	1,163	1,163
West Lothian	678	14%	4%	3%	3%	3%	3%	3%	4%	4%	2%	2%	1,128	1,128	1,128	1,128	1,128	1,128	1,128	1,128

Source: As reported by local authorities on the statistical return Council Tax Assumptions for the respective years

Excludes Water and Sewerage

Source: <http://www.gov.scot/Topics/Statistics/Browse/Local-Government-Finance/DatasetsCouncilTax/BandDCouncilTax1516>

Colour coding

Red = increase over 10%

Amber = increase between 5% and 9%

Green = increase between 1% and 4%

THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND



Response from
The Institute of Chartered Accountants of Scotland to the
Commission on the Future Delivery of Public Services

CALL FOR WRITTEN EVIDENCE

7 March 2011

INTRODUCTION AND KEY POINTS

Introduction

The Public Sector Committee and the Charities Committee of the Institute of Chartered Accountants of Scotland (ICAS) welcome the opportunity to submit evidence to the Commission on the Future Delivery of Public Services. Both committees are broad based committees of ICAS members with representation from across the public services and the charity sector.

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires it to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

In the lead up to the Scottish Parliament election on 6 May 2011, the Institute has prepared a pre-election briefing *Sustainable growth for Scotland* for the political parties. It makes recommendations in a number of areas where we would like government to take action, including creating an environment where innovative and robust joint working arrangements can be brought to fruition and developing funding and procurement practices which enable charities to continue to play a major role in the delivery of public services. A copy of *Sustainable growth for Scotland* is included as part of our submission.

Key Points

- Spending decisions should be made with the longer-term in mind. We believe that innovation in the delivery of public services may depend to an extent on the development of more robust outcome measures which go beyond existing strategic planning horizons.
- Elected representatives and board members of public bodies have a pivotal role in improving organisational performance, financial scrutiny and governance, and providing accountability to stakeholders. Therefore, elected representatives and board members should have an understanding of the financial, legal and regulatory environment of the public bodies they represent.
- Longer-term, we believe that major structural change is likely to be an issue and in the meantime it is important that government seeks answers to some fundamental questions which may eventually drive structural change. Perhaps the most fundamental question of all is the broader economic question, what is the optimum balance between the not-for-profit and private sectors and how can this be achieved? Demography will also be a key factor in shaping the future of public services.
- There are options for reform which fall short of restructuring which require working with other bodies. Implementing robust governance and management arrangements around any form of joint working is essential if efficiencies and service improvements are to be delivered and accountability maintained through such arrangements.
- The Scottish Government should take greater leadership of the shared services agenda so that joint arrangements are more likely to come to fruition. The public sector needs to be fleet of foot in taking this agenda forward, breaking down cultural and other barriers where these exist.
- We have a concern that the risks associated with reductions in public sector budgets could be transferred to the voluntary sector, including charities, accompanied by new conditions and performance measures which could damage the sustainability of charity finances.

- Having the right ‘tone at the top’ will influence the manner in which a public body’s decisions are taken, disseminated and actioned, impacting on the overall culture of the organisation and impacting on external relationships. Each public body may find it worthwhile to reflect on its ‘tone at the top’ at the current time to ensure that ethics and integrity are central to the way it conducts its activities.
- It is important to the future delivery of public services that there are good working relationships between government and charities. Staff involved in commissioning services from charities should have a good understanding of the sector, including charity finances.

RESPONSES TO THE COMMISSION’S BROAD QUESTIONS

Question 1

How best can our public services achieve positive outcomes for and with the people of Scotland?

Response

Reporting performance

The setting and delivery of outcome measures as expressed in the National Performance Framework is a positive aspiration. However, we believe that the move to outcome measures may have been too quick and therefore is not currently based on a sufficiently robust underlying framework. It may have been better to develop output measures first and then develop more sophisticated outcome measures at a later stage. Outputs facilitate the meeting of outcomes and are simpler to develop and to measure than outcomes.

In addition, we believe that national performance indicators may be masking what the real priorities of public bodies actually are and that greater transparency may therefore be needed about local priorities. The performance management agenda is closely linked to improving accountability for decisions and this includes joint accountability where joint working arrangements are established. We set out our views on joint working in our response to question 2.

We support the idea that services provided or commissioned by local authorities are developed to meet national outcomes. However, we are not convinced that the mechanisms for delivering national outcomes have worked well, for example, there do not appear to be any sanctions for local authorities if elements of the single outcome agreements are not met. This highlights how difficult it is to balance central direction with local priorities.

Future innovation in the delivery of public services may depend to an extent on the development of robust outcome measures which go beyond existing strategic planning horizons. Longer-term planning horizons and an integrated approach to resource management (i.e. finances, workforce and assets), particularly in early years’ intervention and in social care, are needed to improve social outcomes and to meet the demands of an ageing population.

Preventative spend

We are aware of the report published by the Finance Committee of the Scottish Parliament following its inquiry on preventative spend and of the Scottish Government’s response to the recommendations contained therein (published on 25 February 2011). We note the Finance Committee’s statement that the way the Scottish public sector is organised is outside the scope of its preventative spend report and we agree with the Finance Committee that the findings of the inquiry will be of interest to the Commission.

In our response to question 2, we set out our views on the organisational structure of the public sector. We also welcome the focus in the preventative spend report on outcomes. We believe that spending decisions should be made with longer-term outcomes in mind and that investment in early years' intervention can result in positive social outcomes and cost savings in the future. We are mindful that preventative spend is not limited to early years' intervention and that there is scope to consider preventative spending in other areas, which would need to be accompanied by outcome measures which can demonstrate the impact of preventative spend over the life-time of a policy.

In terms of achieving positive outcomes, measuring outcomes using the Social Return on Investment (SROI) methodology is proving worthwhile for some public sector bodies. This methodology can show where expenditure incurred by one public body, such as a local authority, can reduce expenditure in other areas, such as policing costs. Therefore, we believe that there is further scope for public bodies to consider using SROI methodology as they seek to develop more robust outcome measures.

Financial skills

Good financial management and effective stewardship are cornerstones of any successful organisation, contributing to positive outcomes. Elected representatives and board members of public bodies have a pivotal role in improving organisational performance, financial scrutiny and governance, and providing accountability to stakeholders. Therefore elected representatives and board members should have an understanding of the financial, legal and regulatory environment of the public bodies they represent. Financial matters should form part of the induction process and also of on-going training programmes.

Board members of Non-Departmental Bodies (NDPBs) face challenges in common with other public bodies. However, the financial, legal and regulatory framework in which they operate requires the application of knowledge experience and judgement within a separate context. The ICAS Public Sector Committee has recently published a guide specifically for board members of NDPBs aimed at strengthening the capacity of NDPB boards to improve performance, financial scrutiny and governance, and accountability to stakeholders. The guide, *Forward planning, reporting back*, is available on the ICAS website at www.icas.org.uk/ndpbguide and is intended to complement the Scottish Government publication *On board: a guide for board members of public bodies in Scotland*.

Chapter 5 of our guide examines the role of the chief financial officer (CFO) in an executive NDPB, highlighting both the accounting role and the strategic leadership role of the CFO. We believe that the CFO in any public body has a key role in helping it develop and implement strategy and to resource and deliver the organisation's strategic objectives sustainably and in the public interest¹. It is good practice for public bodies to have a CFO who is a professionally qualified accountant and we believe that in the current climate all professionally qualified accountants within the public services have a key role to play, working closely with service managers so that the cost implications of decisions are well understood.

There is one aspect of financial information which we believe requires significant improvement across the public services and that is the use of unit costs to benchmark services to support decision-making. In our response to question 2, we set out our views on how the Scottish Government could drive forward the shared services agenda and joint working more generally. Better information on the unit costs of services could assist this agenda by helping public bodies to identify those areas where shared services arrangements have the greatest potential for savings.

¹ CIPFA statement on *The role of the chief financial officers in public services organisations* (June 2009).

Question 2

How best can wider organisational arrangements (including functions, structures and processes) support and enable the delivery of effective services?

Response

An overview of the long-term

Organisational structure has long been a major focus of commentators on the delivery of public services. Given the current economic conditions, we agree that major structural change may not be desirable within the next five years and that public bodies should be looking at new ways of working with other public services providers to identify savings and efficiencies and to drive through service improvements where required.

Given the size of the public services sector in Scotland, for example, there are 32 local authorities, 23 NHS bodies, 37 FE colleges, 45 joint boards, (which will reduce with changes to the police) and over 200 registered social landlords, we believe that in the longer-term major structural change is likely to be an issue. In the meantime it is important that government seeks answers to some fundamental questions which may eventually drive structural change. Perhaps the most fundamental question of all is the broader economic question, what is the optimum balance between the not-for-profit and private sectors and how can this be achieved? Demography will also be a key factor in shaping the future of public services. With an ageing population an increasing percentage of the population will require social care. This long-term issue requires government and public bodies to look much further ahead than is currently the case in terms of strategic, financial and workforce planning.

In its report *An overview of local government in Scotland 2010*, Audit Scotland says:

“There are underlying financial pressures in social work related services from demographic projections which show the numbers of older people rising substantially in the medium and longer-terms; the population aged 60 and over is estimated to increase by 18 per cent between 2008 and 2018, and will be 50 per cent more by 2033. By 2016, the number of older people requiring some sort of care is expected to rise by a quarter, rising to nearly two-thirds by 2032.”

Demographics and the associated demand pressure on services therefore highlight the vital importance of effective working relationships between local government social services and the National Health Service. While questions about whether Scotland should have 32 local authorities and 14 health boards may be for the future, cultural change is required to ensure that joint working arrangements between social services and health, delivered through Community Health Partnerships (CHPs), meet the needs of an ageing population.

CHPs and joint working

There are currently 40 CHPs across Scotland. Each CHP sits within a local authority but it is the relationship between health board geographic boundaries and the catchment areas of GPs where this falls down. The GP practice a person is registered with determines their health board area (and CHP area). However, GP catchment areas and health board boundaries are not co-terminus in a geographic sense so an individual could fall within a CHP area which is not within their own local authority area. We believe that GP catchment areas should be co-terminus with health board areas to enable CHPs to operate effectively.

Some health boards are enthusiastic about CHPs and have developed robust governance and management arrangements, while others have not. Identifying and sharing good practice will become increasingly important with the introduction of 'real budgets' for CHPs; 'real budgets' meaning that health board and local authority money once placed in a CHP budget should be seen simply as a CHP resource. CHPs will therefore be accountable in their own right for the money they spend, for the decisions they take and for service outcomes. Openness between partners within each CHP about budgets will be essential if there is to be proper collective responsibility for financial management. As a general point, there has been a tendency in the past for partners with pooled budgets to protect their own share of budget and this will need to be avoided if CHPs are to reach their potential.

We understand that Audit Scotland is undertaking a review of CHPs which will be published after the May 2011 election.

Supporting a shift in public service delivery

The CHP model demonstrates that there are other options for reform which fall short of restructuring but which require working with other bodies. Implementing robust governance and management arrangements around any form of joint working are essential if efficiencies and improvements are to be delivered and accountability maintained through such arrangements.

Discussions among potential partners can soak up a great deal of management time and often do not get any further than the drawing board. Today's financial imperatives may help drive through barriers to shared services. However, the Scottish Government needs to take greater leadership of this agenda so that shared services arrangements are more likely to come to fruition where there are efficiencies to be gained, for example through encouraging managed risk taking. The public sector needs to be fletter of foot in taking this agenda forward, breaking down cultural and other barriers where these exist. As referred to in our response to question 1, we see the development of unit costs for the benchmarking of services as a key part of the decision-making process around shared services.

In *Sustainable growth for Scotland*, we recommend that the Scottish Government updates the shared services framework it produced in 2007 to provide support to public bodies in developing sound business cases for partnership working, including working with organisations outside the public sector. An updated framework should include material on the legal and tax issues which could provide significant challenges to joint working arrangements, depending on the structure of the arrangement. For example:

- The ability of a public service provider within the not-for-profit sector to reclaim VAT on services could have a significant and recurrent impact on the cost of delivering shared services, depending on the specifics of any arrangements and the type of body it is. Local authorities are normally able to reclaim VAT incurred from suppliers but this is not the case for other public service providers within the not-for-profit sector.
- If employees are transferring from one organisation to another under a joint working arrangement, the crystallisation of any liabilities, such as those arising from obligations under TUPE, will need to be identified and included within the business case.
- All public bodies are required to comply with public procurement rules arising from the EU and the extent to which these apply to joint working arrangements will depend on the parties involved and the detailed structure of the arrangement. If an arrangement is sufficiently contractual or commercial, even if it involves public sector bodies only, public procurement rules could apply.

Capital investment in infrastructure

Throughout our submission we emphasise the importance of longer-term planning horizons and delivering the infrastructure Scotland needs is an essential element of long-term plans. We recognise the mechanisms available to the Scottish public sector to fund capital projects have evolved in a manner which does not appear to be fully fit for purpose. We welcome the discussions around borrowing powers which are taking place as part of the scrutiny of the Scotland Bill in both the Scottish and UK Parliaments. However, we believe that the development of appropriate funding mechanisms for capital projects should be the subject of policy development initiative which is specifically focussed on this issue. We see this as a priority for the Scottish Government, which will require the full engagement of the UK Government.

Communicating with the public

Managing public expectations through good external communications is very important. The public needs to understand what is possible. This is the responsibility of both elected representatives and other leaders. It also means that public bodies, which have elected representatives, and those whose leaders are appointed, need a good understanding of how the nature of organisations' leadership arrangements impacts on any joint working arrangements. In local government, the elected membership role is vital in providing community leadership. The success and well-being of their local areas depends on it.

Working with the charity sector

In *Sustainable Growth for Scotland*, we highlight a number of issues, accompanied by recommendations, where we believe government can ensure that the charity sector continues to play a major role in the delivery of public services. We have an overarching concern that the risks associated with reductions in public sector budgets could be transferred to the voluntary sector, including charities, accompanied by new conditions and performance measures. In our response to question 3, we highlight that this may already be happening.

In relation to the charity sector, we recommend that:

- Public sector funders give proper consideration to the financial and governance risks to a charity of having to subsidise any shortfall between the actual cost of the public service provided and the amount of contract income it receives.
- Local government, should as far as possible, develop consistent arrangements for the award of grant funding and for performance monitoring, including the reporting of outcomes. Commercial tendering processes, such as tender documents, and performance monitoring arrangements should also be consistent as far as practicable. More consistent arrangements are likely to improve the quality of the information provided by charities and enable charities to use their own resources more efficiently.
- Public bodies entering into contracts with charities should understand how charities are affected by VAT rules and rules on charitable trading. They should also be able to explain to charities how they are affected by these rules so that charities can make informed decisions about registering for VAT and how to structure their business.

Charities and other organisations, which are successful in winning contracts for services which are already being provided on behalf of the public sector, carry significant financial risks in relation to TUPE. The successful organisation may incur additional costs and liabilities which arise from obligations towards the staff of the previous provider. Public sector funders should have an understanding of how TUPE could impact on the sustainability of charity finances and those of other organisations.

We are supportive in principle of the idea of self-directed care, for people who have the ability to make informed decisions or who have support in doing so. However, we are concerned that part of the care package can be spent on unregulated care and we believe that there are significant risks to individuals from the purchase of unregulated care. Charities are now starting to experience bad debts on self-directed care. This could result in poor publicity for charities which pursue bad debts from the vulnerable and this is an example of charities taking on financial risk from the public sector.

We believe that the focus on reducing costs may favour larger service providers and we recommend that local authorities consider the “bigger picture” as part of any commissioning process, including the contribution which smaller charities can make to service quality. We are already aware that such a shift is taking place in some areas and raise a number of issues in this regard:

- If size becomes a genuine barrier to winning local government contracts, service innovation could be stifled.
- It is possible that local charities could be forced to merge by local authorities with the objective of reducing the cost of back office services. While rationalisation or reorganisation may be the correct approach in some instances, it is important that these are not pushed through at the expense of service innovation.
- Local authorities are now more likely to commission services under the broad category of “special needs”, rather than recognising them specifically. For example, autism will now be included within contracts under the broader category of learning disabilities. Such an approach could damage service quality if sufficient recognition is not given to the fact that different special needs require particular specialist care.

Question 3

What shared values and ethos should underpin public services, and how best can they be embedded in the delivery of public services in the future?

Response

Setting the ‘tone at the top’

At the moment those who deliver public services are under enormous pressure, there is great uncertainty about government funding and how cuts will impact on all public service providers including charities. There are also genuine fears about job losses. Within this context, providers are being asked to maintain services to the public and to look for innovative ways to increase efficiency and to improve quality. In this context it is vital that there are strong working relationships between individuals and between public service providers. It is important for each public body, whether its leaders are democratically elected or appointed, to have a ‘tone at the top’ which is based on ethical principles and integrity. Having the right ‘tone at the top’ is a key governance issue and will influence the manner in which decisions are taken, disseminated and actioned, impacting on the overall culture of the organisation and impacting on external relationships. Each public body may find it worthwhile to reflect on its ‘tone at the top’ at the current time to ensure that ethics and integrity are central to the way it conducts its activities.

The ICAS Ethics Committee is working on a project to develop high level corporate values, which could apply across any entity. Work is due to be completed in late spring 2011 and we will forward details of the Committee's findings to the Commission when these are published. In addition, Audit Scotland has prepared material which may be of interest to public bodies in considering the 'tone at the top', including performance improvement, for example: the report *How councils work: an improvement series for councillors and officers - Roles and working relationships: are you getting it right?* (August 2010); and the Best Value toolkits, available on the Audit Scotland website, which cover a number of topics including the cross-cutting themes of equalities and sustainability.

Public services are valued and it is important for the public to respect those who provide public services. Government has an important role in promoting public service as a positive career choice so that in future it can attract highly motivated, committed and capable individuals to work in all areas of the public sector and at all levels.

Listening to views from the front-line

While it is for government to set the direction for the future of public services, reform should be evidence-based. It is therefore vital that policy-making involves listening to the views of the people in the public, voluntary and private sectors who are at the front-line of delivering services.

We also envisage that stakeholder engagement will continue to be an important element of public bodies strategic and business planning processes, particularly as changes to services are being planned and rolled out. Community engagement and obtaining good quality information on service users' views can inform service choices and performance management arrangements.

Building good working relationships with the charity sector

In *Sustainable growth for Scotland* we highlight the vital role that the charity sector plays in Scottish society and in our discussions about shared values and ethos we acknowledged the importance of good working relationships between government and charities which deliver public services. It is very important that the staff involved in commissioning services from charities have a good understanding of the sector, including charity finances, which are complex. The ICAS Charities and Research Committees have issued a call for research on the financial sustainability of UK charities. One element of the research is to gauge how well funders understand charity finances and how this impacts on their funding decisions. We expect the research report to be published in spring 2012 and we would welcome the opportunity to share the results of the research, including any interim findings with the Scottish Government.

We believe that local authorities have not yet found the correct balance between accountability and transparency in their dealings with charities. This has led to the intense scrutiny of charity budgets, in the commissioning phase, and has left charities with the impression that they are not fully trusted. This process also appears to be indicative of local authorities seeking to increase their terms and strip out costs without proper consideration of the consequences for charity finances.

We understand that in the current climate there is a huge emphasis on cost. However, there is concern that cost is becoming the main driver and that quality and sustainability of service is not being given sufficient priority. The development of outcome measures by the charity sector has been slow and could be further hindered if the correct balance between cost and quality is not considered by public sector funders.

As funding cuts begin to bite, there is a risk that working relationships between charities and local authorities deteriorate and we have started to see instances of this happening. We are aware of charities entering discussions with local authorities and through these discussions believing they have reached agreement about the price and the configuration of a service only for it to emerge that the local authority had decided on a price cut prior to the discussions taking place. This approach damages the reputation of local authorities and their staff and adversely affects the level of trust charities place in their funders. As a general point, when commissioning services, public sector funders should recognise that organisations have contractual commitments to suppliers and staff which have to be met even if funding is cut. Contractual commitments take time to change, usually longer than the timescale for the introduction of reduced funding.

In awarding contracts to charities, public bodies should also consider whether the length of contracts are sufficient to enable charities to develop, deliver and maintain the services which are wanted. In our view, the length of contracts, which are generally between three and five years, depending on the service and the public body awarding the contract, are too short and this raises a number of issues. For example, vulnerable individuals benefit from having continuity of care throughout childhood and a change in provider can be disruptive, risking negative social outcomes. Also, in order to deliver services charities have to take on contractual commitments in relation to employing staff and leasing property. Some charities will need to invest capital in specialist properties to deliver services and the duration of contracts tend to be shorter than the useful life of these properties. Charities experience a risk transfer if the commitments they have to take on in relation to a public sector contract extend beyond the length of that contract.



VAT and the Public Sector

12 December 2014

EXECUTIVE SUMMARY

It is time to take a fresh look at the UK VAT regime for the public sector. Changes to the way in which public services are delivered, together with public spending restrictions, have highlighted the impact of VAT on decision making across the sector. Too often it seems the focus is on HMRC getting the maximum amount of tax from the public sector, rather than efficient delivery of services.

ICAS members consider it is time to review the current VAT regime for the public sector to address the following issues:

- The differing VAT status of parts of the public sector under the UK rules gives a VAT recovery shelter to some organisations but not other organisations delivering the same services to the same end users. There are strong arguments to suggest that the UK VAT system for the public sector is not fiscally neutral.
- The Autumn Statement on 3 December 2014 included five separate announcements to adjust the VAT status of various bodies delivering public services. The need to make this number of changes illustrates the piecemeal way of addressing these concerns and indicates that a broader review of VAT and the public sector is needed. This call is not new - it was also outlined in the Monitor report on “A fair playing field for the benefit of NHS patients” in March 2013.
- The differences in VAT recovery act as a disincentive to implement new and innovative service delivery models across the public sector. Moving activities traditionally delivered by an organisation within a VAT shelter to a new organisation unable to benefit from VAT recovery these will increase the costs of providing that service by 20% before any other changes are contemplated.
- The administration of VAT in the public sector should be carried out by a specialist team within HMRC to harness expertise in dealing with the complex VAT issues involved along with an understanding of the bigger picture. We have outlined below the complexity of the VAT rules applying to the public sector; having a specialist team can help alleviate some of the complexities and help the public sector get its VAT position right more of the time.
- The public sector procurement rules have raised issues about the planning undertaken by the sector to minimise the impact of taxes on their operations. There are conflicting demands on the sector from the interaction of these rules with the need to get the best possible return for public expenditure. Coherent clarification is needed of the procurement rules, particularly around what are considered “artificial avoidance schemes”. We would suggest looking at the types of planning outlined in this document to illustrate “safe harbour” arrangements that are accepted to allow VAT recovery.
- The money to fund large parts of the public sector comes from tax revenues and disputes between HMRC and the public sector about VAT can give the impression that vital public resources are being used to fund what appear to be internal or trivial issues. It is in the interests of all parties to make the system work effectively and deliver good public services and the intended tax outcomes.

1. BACKGROUND

In April 2014 ICAS responded to a consultation issued by the European Commission on the impact of the current VAT system on public sector organisations¹. This project identified a number of areas in the UK's system where the current rules give rise to distortions in the way that different parts of the public sector are subject to VAT on essentially the same transaction. ICAS has been asked by its members to look in more detail at the position and identify areas where the UK Government should focus its attention on ensuring a level playing field across the public sector.

Our focus in this area has also been informed by the public sector procurement rules. These rules were changed from 1 April 2013 for central government contracts of more than £5 million and require bidders for these contracts to self-certify their tax compliance as part of the tender process. The introduction of these rules has had an impact across the public sector and many organisations find themselves in the position of needing to include information on tax compliance on tenders to national governments. This is against a background where there may be strategies adopted by public sector organisations to maximise VAT recovery that appear to be in contravention of this rule, even where these are treated as acceptable tax planning by HMRC.

Definition of public sector

The term “public sector” needs to be clarified. We are using this term in this paper to cover all not for profit organisations as the VAT issues are common across the sector. We have used the term to include:

- Central Government.
- Local Government.
- The public health sector – the NHS.
- The public education sector.
- The charitable sector.

2. UK LEGISLATION – CATEGORISATION OF VAT ENTITIES

The UK has applied article 13 of the European Directive² by implementing specific rules regarding the VAT treatment of public sector organisations which splits these organisations into four types:

- Local Authorities and similar organisations (including the BBC) – section 33 VATA 1994 allows these organisations to recover all VAT incurred on activities related to the non-business functions of the organisation. There can be issues where the organisation receives non-statutory sources of income where these new activities are outside the scope of section 33.
- Government departments and the NHS and associated organisations – Section 41 VATA 1994 allows these organisations to recover input VAT in certain circumstances but they cannot recover VAT on non-business activities. The Treasury lists the services on which these departments are able to receive funding to compensate for irrecoverable VAT in the London, Edinburgh and Belfast Gazette.

¹ A copy can be found at <http://icas.org.uk/Technical-Knowledge/Tax/Consultations-and-Submissions/>

² The text of the Article is as follows:

“States, regional and local government authorities and other bodies governed by public law shall not be regarded as taxable persons in respect of the activities or transactions in which they engage as public authorities, even where they collect dues, fees, contributions or payments in connection with those activities or transactions.

However, when they engage in such activities or transactions, they shall be regarded as taxable persons in respect of those activities or transactions where their treatment as non-taxable persons would lead to significant distortions of competition.

In any event, bodies governed by public law shall be regarded as taxable persons in respect of the activities listed in Annex 1, provided that those activities are not carried out on such a small scale as to be negligible”.

- Other public sector organisations – these are organisations that do not have any specific provisions that allow them to recover VAT on their activities which are for the public good. These organisations use the standard income method to split their activities between business and non-business, and operate an appropriate partial exemption method to determine what input tax can be recovered. In the UK organisations dealt with under these arrangements are mainly charities, housing associations, universities. In effect, these public sector bodies are not treated under article 13 as they are not “bodies governed by public law” as defined by the Principal VAT Directive.
- Non-Departmental Public Bodies (NDPBs) which are effectively a separate category for VAT purposes. These are organisations which have a role in the processes of government, but are not a Government Department or part of one, and which accordingly operate to a greater or lesser extent at arm’s length from Ministers. As these organisations are separate from central government they do not benefit from the section 41 treatment unless they are Crown NPDBs. An NDPB is only able to register for VAT where it makes taxable supplies and can only recover VAT in connection with those supplies and its residual input tax allocated to those supplies under the partial exemption method adopted. This can be a very complex area as the funding of NDPBs relies on grants from Government and often this funding is calculated on the basis that VAT can be recovered in line with section 41 VAT 1994. It is only once plans to transfer services to the NDPB are advanced that VAT is considered and there can be significant issues to overcome in this area.

3. IMPACT OF UK LEGISLATION ON CATEGORISATION

To demonstrate how these regimes would work in practice, consider the example of an organisation in each category incurs £1,000,000 input tax on implementing a new payroll solution across the organisation where the work was outsourced to an external contractor. The VAT recovery position would be:

- Local authority – would be able to recover the £1,000,000 in full under the terms of section 33.
- Central government, NHS – would be able to recover the £1,000,000 in full under the terms of section 41 provided the services were covered by the Treasury List.
- Other public sector organisations – universities, charities etc – if the organisation was able to be VAT registered the £1,000,000 input VAT would be treated as belonging in the partial exemption “pot”. Partial exemption is the method used to allocate input tax incurred on general activities in proportion to an organisations ratio of taxable supplies to total supplies. These types of organisations will have predominantly exempt supplies so full recovery is not possible. Assuming a recovery rate of 15% (this figure is illustrative of the VAT recovery rate for the sector) would mean that the organisation would only be able to recover £150,000 of the VAT incurred, leaving it with a balance of £850,000 to cover with funding from other sources.
- NDPBs - if the organisation was able to be VAT registered the £1,000,000 input VAT would be treated as belonging in the partial exemption “pot” with similar issues as above. The partial exemption rules would apply to these organisations but as they carry out government functions which are non-business for VAT, they are unlikely to have very significant levels of taxable supplies. Assuming a recovery rate of 5% (this figure is illustrative of the VAT recovery rate for the sector) would mean that the organisation would only be able to recover £50,000 of the VAT incurred, leaving it with a balance of £950,000 to cover with funding from other sources.

This example demonstrates the wide variation across the public sector and the value to the organisations of the statutory shelters in sections 33 and 41. It also illustrate the issues associated with transferring responsibilities from within government to new organisations – either NDPBs or other types of organisations – and the impact on funding for the new organisations.

The VAT cost is a significant burden, and at the moment these rules act as a disincentive to implementing new strategies for delivering public services. There is not a level playing field across the public sector and we believe it is time to address this issue within the UK.

To try and illustrate how this affects the running of the public sector we have looked at two scenarios where the same transaction carried on by bodies with differing status has a very different tax impact.

1. Categorisation example 1 – social housing

The first example is the provision of social housing which is exempt from VAT in the UK. Where the housing is provided by a local authority they are able to recover the VAT incurred on repairs and maintenance under the generous partial exemption de minimis rules available to local authorities. If the same housing is provided to the same tenant by a Housing Association they are not able to recover these amounts of VAT. A Housing Association is generally a not-for-profit body which may have charitable status and is likely to receive public money; many evolved from the outsourcing of social housing provision in the UK.

The VAT anomaly can lead to issues when there are transfers of social housing stock from the local authority sector and where the successor landlord does not benefit from the local authorities' VAT shelter outlined above. This can result in convoluted structures to allow the repair and maintenance obligations to remain with the local authority so that VAT can be recovered as the cost of making a complete transfer of all obligations is the 20% of VAT incurred on repairs and maintenance. There are significant professional and legal costs associated with structuring the transaction in this way. The bulk of these costs are on the initial transaction but there are on-going compliance costs.

To give some idea of the financial impact of the VAT in these cases we have looked at the VAT costs of refurbishment programmes under housing stock transfers from Glasgow City Council. The technical issue concerned the recovery of VAT on future refurbishment costs associated with the social housing. As noted, housing associations do not fall into the section 33 shelter available to local authorities and cannot recover VAT incurred on refurbishment work. The additional cost of this VAT threatened the financial viability of the transfer of social housing stock and the third party funders pushed for action to mitigate this cost so the transfer could proceed. A structure was designed, with HMRC consent, to effectively allow the cost of refurbishment to remain with the local authority.

Glasgow Housing Association acquired the social housing stock of Glasgow City Council in 2003 with an intended budget of £1.47 billion for refurbishment costs. The level of future costs anticipated on refurbishments where Glasgow Housing Association includes both the debtor due from Glasgow City Council and the creditor for future upgrades disclosed at 2012 is £250 million.

As indicated by the example above, it is possible to enter into contractual arrangements which benefit from the VAT recovery position of the local authorities. However, without detailed approval from HMRC this type of tax planning could be seen as falling foul of the guidelines included in the Treasury document "Managing Public Money" issued in April 2013 which states at paragraph 5.6.1:

"Public sector organisations should not engage in, or connive at, tax evasion, tax avoidance or tax planning..... artificial avoidance schemes should normally be rejected".

The guidance notes that tax advisers can be used for normal compliance activity but it casts doubt on the ability of Government bodies, including NDPBs, to adopt planning strategies which are justifiable in terms of deliverables and governance if one of the aims is also to maximise the VAT recovery on their activities. There is a tension between this requirement and the need to use public money effectively. Paying more tax than is required could be the result of this tension.

2. Categorisation example 2 – “relevant residential purpose” or “relevant charitable purpose”

The other example to consider is the provision of accommodation for “relevant residential purposes” or “relevant charitable purposes”. Where the developments falls within either of these categories the construction work will be zero-rated with no VAT cost charged on construction costs from the main contractor. This zero-rating covers most work on student accommodation for Universities and work for charities on providing premises to be used for the non-business activities of the charity.

On substantial capital projects of this nature there are normally significant costs from architects, surveyors and other consultants which cannot be treated as part of the construction and are subject to VAT at 20%. If these costs are incurred by either a university or charity the VAT incurred would not be recoverable.

The approach to this that has been used is for the university/charity to set up a separate subsidiary to act as the main contractor on a design and build contract for the organisation. This structure allows the subsidiary to use the composite supply rules to zero-rate the whole supply it makes to the organisation – so it is able to recover all the VAT incurred on associated architects, surveyors’ etc. costs. Using a separate subsidiary is the method used to ring-fence the property activity and make sure that the VAT can be recovered while giving the organisation the control over the appointment of main contractors on the project and apply for funding for the project while under the control of the organisation.

This is a normal planning strategy, and has been accepted by HMRC. HMRC reviewed the position in 2011 as a result of the Talacre case at the European Court of Justice (C-251/05) and after discussion with the Charity Tax Group decided that the treatment as a composite supply would be available for zero-rated construction services in Group 5 Schedule 8 VATA 1994. The Charity Tax Group took Counsel’s opinion on the issue as part of their discussions on the issue and HMRC accepted that the Talacre judgement did not affect the approach in these particular circumstances.

3. PUBLIC SECTOR PROCUREMENT RULES

As the planning for transfer of housing stock outlined above demonstrates, this is tax planning by the public sector to enhance VAT recovery. The procurement rules across the whole public sector will require organisations to consider whether they can justify the use of this type of planning to eliminate VAT costs on property transactions. To the man in street, the use of a single purpose vehicle property development company can look like part of an avoidance scheme and using this type of structure does not add to overall transparency. There is now a tension between planning for financial viability and the need to be seen to be tax compliant even if this would mean a higher tax bill for the organisation.

4. ADMINISTRATIVE COMPLEXITIES

4.1 Business and non-business activities

There are further layers of complexity in VAT recovery for public sector organisations in dealing with VAT. The first step is that these organisations will be involved in splitting their activities between business activities and non-business activities. This is a complex area in itself and there is a wealth of case law that covers the issue, along with a full manual of guidance for HMRC staff at <http://www.hmrc.gov.uk/manuals/vbnbmanual/index.htm> .

4.2 Partial exemption

Once this has been calculated the organisation then has to consider its partial exemption position applicable to its business supplies. A large number of public sector organisations are partially exempt – their supplies for VAT purposes include both taxable supplies and exempt supplies – and they are required to agree a formula with HMRC for apportioning the input VAT that is incurred across the business activities of the organisation between its taxable activities and its exempt activities.

This can be a very complex process and involves work to ensure that the accounting system and the staff who operate the system can distinguish between taxable and exempt supplies and purchases. For example, it becomes important that income from car parking activities is allocated to either taxable or exempt for some organisations. The operation of the partial exemption scheme is dependent on this level of detail being available to complete the calculation for all public sector bodies.

5. ADMINISTRATIVE COMPLEXITY PARTICULAR TO THE PUBLIC SECTOR

There are a number of areas where there are particular problems for public sector bodies as a result of the complexity of UK VAT regulations and this paper will now go on to consider these in more detail to give a flavour of the types of issues that these organisations have to deal with in practice. The examples to be covered are:

- Issues around prescribing within the NHS.
- Issues around cost sharing across the public sector.

1. Administrative complexity example 1 - prescribing within the NHS

The NHS is treated in a very complex way by the VAT rules and their interpretation by HMRC. We are focusing on the issue of prescribing within the NHS as a discrete issue but in the bigger picture the rules around partial exemption calculations and the interaction with contracted out services cause significant practical issues for the day to day running of the NHS. The HMRC guidance on this issue is here <http://www.hmrc.gov.uk/menus/frame-nhs.pdf> and gives some flavour of the issues and problems associated with this area

As noted above the NHS is a section 41 organisation and is able to recover input VAT in certain circumstances. For most of the organisations covered by section 41 the supplies they make are outside the scope of VAT or exempt so there is no requirement to account for VAT.

Prescription services offered by the NHS are zero-rated for VAT in certain circumstances under Group 12 of Schedule VATA 1994. This means that the VAT incurred in purchasing the medicine can be recovered while there is no VAT to be accounted for on any prescription charges.

The UK legislation in this area applies the zero-rating as follows:

“1) the supply of any qualifying goods dispensed to an individual for that individual’s personal use on the prescription of an appropriate practitioner where the dispensing is:

- a) By a registered pharmacist; or
- b) In accordance with a requirement or other authorisation under a relevant provision”.

There is HMRC guidance which defines the terms used in the legislation so that most prescriptions issued under the NHS prescribing guidelines fall into this zero-rating. It is worth noting that drugs and medicines supplied in hospital are treated as part of a supply of healthcare to the patient which is outside the scope of VAT and the VAT incurred by the hospital on these drugs and medicines cannot be recovered by the NHS.

However, there are developments in the ways that prescriptions are issued by the NHS in line with policies to try and reduce the pressure on general practitioner workloads. One of the areas that is causing difficulties from a VAT perspective is prescribing by local clinics for medicines to be used by non-named individuals, and thus outside condition one. This occurs for many emergency prescriptions such as for drug treatment where the clinic is not able to get a suitable prescription for the individual. If the conditions cannot be met, the supply is treated as standard-rated so that the clinic is required to account for VAT on the cost of the drugs or medicine and this can create significant problems.

There are plans to expand the powers of local clinics in this area, and it is likely that they will be able to issue emergency prescriptions for a wider range of drugs and medicines, including expensive cancer treatment drugs. This additional VAT cost will have significant impact on funding for the NHS and it is vital that HMRC adapt their guidance to ensure that it reflects an up to date approach to prescribing within the NHS.

2. Administrative complexity example 2 - cost sharing across the public sector

In July 2012 legislation was passed that allows an independent group of persons to form cost-sharing groups to provide shared services without charging VAT in line with Article 132.1(F) of the Principal VAT Directive. Until this legislation was introduced, organisations were able to set up cost-sharing groups but the services provided by the cost-sharing group were subject to VAT which is a disincentive where organisations are not able to fully recover VAT. The legislation is intended to combat this position and allows the cost-sharing group to treat its services as exempt from VAT. This VAT exemption gives the group the scope to realise the savings of shared services without the additional VAT costs.

The UK legislation is rules based and is included in Group 16 Schedule 9 VATA 1994. The primary conditions are as follows:

- There must be an independent group of persons supplying services to persons who are its members.
- All the members must carry on VAT exempt and non-business activity.
- The services supplied by the cost-sharing group must be directly necessary for a member's exempt and/or non-business activity.
- The Cost-sharing group must only recover the member's individual share of the expenses incurred by the cost-sharing group in making supplies to its members.
- The application of the exemption to the supplies made by the cost-sharing group must not likely to cause a distortion of competition.

As with most rules-based tax legislation the terms used are further defined, and these impose additional conditions for organisations who are considering whether a cost-sharing group would be appropriate to their circumstances. The conditions outlined above include a requirement that the services supplied are "directly necessary" to a members exempt and/or non-business. HMRC interpret this as requiring that the organisation has exempt/non-business activity which represents at least 85% of the total activities.

For many Higher Education Institutions and charities, this limit is very problematic as they are actively involved in trying to generate more business income to address funding concerns – through business partnerships, holiday rentals, consultancy work etc. The conflicting demands of funding issues for the organisation may mean that it cannot satisfy this test and it cannot be involved in cost-sharing groups. The 85% threshold is not included in the Principal VAT Directive and was included by HMRC primarily to prevent organisations with higher levels of taxable activity using this as an opportunity to manage their VAT position.

The conditions outlined also illustrate the complexity of the legislation for the public sector. To be able to determine if they are within the conditions the organisation must undertake a number of calculations using accurate and reliable information and understand all the strands of its activities. This ought to be straightforward – but as recent Tribunal cases such as Brockenhurst College TC02569 demonstrate, this is still an area where organisations need to keep up to date with developments.

This rules based interpretation of the Principal VAT Directive into UK legislation illustrates some of the major issues for the public sector. The UK legislation is driven by rules rather than principles and these particular rules narrow down at each stage of the process the organisations that are eligible for the shelter provided. The legislation does not focus on helping organisations to cost-share and includes anti-avoidance rules within the relief granted – the 85% test and the requirement that this exemption does not distort competition. The underlying attitude which appears to be evidenced by the legislation is that organisations are trying to take advantage of the VAT system, when in fact most organisations are trying to understand and comply with their responsibilities under the UK's tax laws.

CONCLUSION AND CALLS TO ACTION

This paper has examined the distortions in the operation of the UK VAT system and their impact across the public sector. The current situation does not give a level playing field and many of the distortions give rise to financial issues for public sector operations. The real challenge is to find a system for dealing with the VAT affairs of the sector which is less complex for both the taxpayer and HMRC – the examples above illustrate the complexities that face the sector when dealing with VAT issues.

There is a very strong argument for HMRC to treat the public sector as a special sector administratively and have dedicated resources allocated to dealing with the issues from this sector. We are aware of HMRC's diminishing resources and recognise the need for careful allocation of those resources to the areas which carry most risk. The value of transactions within the public sector is itself a risk and public bodies themselves do not often have internal resource with sufficient knowledge to deal with complex VAT queries. This can result in very difficult decisions when organisational finances are being considered. A dedicated team which is open to discussion with both public bodies and their external advisers would be able to make better use of their resources in managing the sector.

A dedicated team would be more aware of the bigger picture for the sector and have an understanding of the wider impact. An example of this in the past was the HMRC dedicated NHS team, which met with external advisers on a quarterly basis and issued newsletters on current VAT issues to NHS Trusts and Boards to ensure consistent compliance across the sector. These newsletters gave the NHS bodies and their advisers clear informed guidance on the VAT treatment of transactions, and allowed HMRC to focus on the exceptional transactions rather than the day to day transactions. We understand from our members that there are concerns that the public sector is now seen as a "soft touch" for HMRC staff.

The UK tax system has not adapted to the changes in the way that public services are delivered in the UK, particularly under single outcome agreements, and often new methods of delivery are not able to use the shelters of section 33 or section 41. The planning to try to allow some of those benefits to remain can mean very significant professional costs and even disputes between the organisation and HMRC.

As noted in the executive summary, there were 5 announcements in the Autumn Statement on 3 December 2014 to adjust the VAT recovery status of various bodies delivering public services. The changes cover:

- Hospices – paragraph 2.20 of the Autumn Statement
- UK search and rescue and air ambulance charities – paragraph 2.80 of the Autumn Statement
- Highways Agency – paragraph 2.107 of the Autumn Statement
- Certain Government departments – paragraph 2.108 of the Autumn Statement
- London Legacy Development Corporation – paragraph 2.109 of the Autumn Statement

The need to make these changes is driven by the underlying issues in the UK VAT legislation covering the public sector. It is time to consider a full review rather than make occasional changes for certain organisations.

There needs to be recognition of the amount of public money that is devoted to these issues and for a review of the whole system for dealing with VAT and the public sector. The piecemeal approach adopted to date has meant that HMRC do not keep pace with changes in the sector. A new approach that looked at principles rather than rules would benefit this sector and provide a system that is better able to deal with the challenges facing the public sector and its finances.