

Cabinet Secretary for Finance and the Constitution

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Rt Hon Philip Hammond MP
Chancellor of the Exchequer
HM Treasury
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Dear Philip

I am writing to set out the key issues that the Scottish Government wishes to raise ahead of the Autumn Statement on 23rd November.

The EU Referendum result has led to heightened uncertainty, and there are signs of weakness entering the UK economy as a result. It is therefore vital that the Autumn Statement delivers a range of measures to stimulate the economy through increased investment to keep the recovery on track.

Implications of Brexit

It is imperative that the devolved administrations have full involvement in the process for negotiating new terms with the EU, particularly given the overwhelming desire of Scotland to remain part of the EU. The form of hard Brexit we understand is being proposed by the UK Government will clearly have a negative impact on investment and our economy. That is why protecting Scotland's relationship with Europe and retaining full membership of the single market, is crucial to us.

Until such negotiations are concluded, it is essential that businesses are provided with certainty and guidance to ensure that investment and job creation is not impeded. The Scottish Government is working hard to secure Scotland's continued relationship with Europe and has set out plans for a £500 million Scottish Growth Scheme to support businesses, for which I welcome your support. In contrast, the UK Government has been silent on the actions it is proposing to take to support the economy both during and after negotiations and that must be addressed in the Autumn Statement.

The biggest boost that you can deliver to businesses across the UK would be to give the assurance that the UK Government will seek continued membership of the single market in your negotiations with the EU. I urge you to take that important step and provide the certainty that the economy needs.

Fiscal Consolidation

I was encouraged by your recent announcement that the target to reach a budget surplus by 2019-20 will be abandoned at the Autumn Statement. The Scottish Government has called for this policy to be dropped on a number of occasions and instead for a current budget balance to be targeted instead. The Resolution Foundation recently estimated that this would avoid the need for any further tightening, despite the deterioration in the public finances, and could provide the choice to borrow an additional £61 billion cumulatively over the period to 2020-21 which could be invested in capital.¹

Introducing more flexible fiscal rules would therefore enable the Scottish Government to further stimulate economic activity. Waiting to take action until the economy has actually entered a downturn would be reckless. Acting now can mitigate the negative impacts of Brexit on both economic growth and public sector revenues and put the UK economy on a strong and more stable footing.

Under your government's current plans, the Scottish Government is already facing real terms cuts every year until at least 2019-20. Taken together with the cuts implemented in the previous Parliament, this means our discretionary budget will have been cut by £3.3 billion in real terms, or 10.6%, since 2010-11. Within this, our capital budget will have fallen by £600 million or 15.7%.

The Scottish Government, using its limited powers, swiftly took action after the EU Referendum vote to support the economy by bringing forward an additional £100 million of capital investment. I welcome your recent announcement to increase capital investment at the UK level. As the Scottish Government has continued to highlight, given record low interest rates, this is an ideal time for limited additional borrowing to support capital investment which will boost the country's long term productive capacity and in turn its ability to create jobs and future tax revenues.

As I and my counterparts from Wales and Northern Ireland made clear at the recent Finance Ministers' Quadrilateral meeting with the Chief Secretary, it is also imperative that existing devolved budget settlements for 2017-18 and beyond should not be reopened negatively, given the impact that further budget reductions would have on investment in the economy and public services.

North Sea

The North Sea Oil and Gas industry continues to face substantial challenges. While production increased by over 10 per cent in 2015, there has been a record fall in

¹ <http://www.resolutionfoundation.org/wp-content/uploads/2016/11/Taxbase-FINAL.pdf>

investment and exploration drilling is at an all-time low. If not addressed, these trends will impact on the long-term sustainability of the sector.

The Scottish Government is continuing to do all it can to support the sector through our devolved powers. The Autumn Statement should deliver measures, which demonstrate the UK Government's commitment to the industry and the jobs and communities it supports. There are three key actions which the Scottish Government considers a priority for action:

1. Improve access to decommissioning tax relief

In order to achieve the tripartite commitment to Maximise Economic Recovery from the North Sea, it is essential that assets are in the right hands and there are no barriers to late life asset transfers. This is of particular significance when fields are maturing and opportunities exist for companies with a competitive advantage, or focus in operating late-life assets, to assume ownership. The UK Government should take steps in the Autumn Statement to allow the transfer of corporate tax history, along with the transfer of an asset and associated commissioning liability, to close the value gap that exists between a seller and potential buyer. Addressing fiscal barriers to asset transfers could extend field life and reduce decommissioning costs – both of which will have a positive impact on exchequer revenues.

2. Urgent clarity on the use of loan guarantees

Nine months on from the announcement at the March 2016 Budget, there is now a pressing need for the UK Government to work directly with the industry to agree and deliver loan guarantees for critical offshore infrastructure. The Cabinet Secretary for Economy, Jobs and Fair Work previously met with HM Treasury in June 2016 to discuss delays to this process, and while receiving assurances that plans will be developed, nothing has yet materialised. The Autumn Statement should reaffirm the UK Government's commitment to provide loan guarantees, which could be important for unlocking capital investment and stimulating investment. This is of vital importance to the supply chain, which is being hardest hit by the recent slowdown and requires immediate support. Without greater investment and activity we risk losing vital capacity and skills in the supply chain that will support production and ensure we realise the total value from maximising economic recovery from the North Sea.

3. Measures to stimulate exploration

With exploration levels currently at record lows, the UK Government should take further action to stimulate exploration. The Scottish Government has previously proposed a number of policies - such as the introduction of an Exploration Tax Credit or reforms to the Investment Allowance to widen eligibility for unsuccessful exploration. I also understand the UK Government has shown a lack of progress on proposals put forward by the industry itself. The Autumn Statement should include

measures to support exploration activity and ensure the 20 billion barrel potential of the North Sea is realised.

Welfare Cuts

I welcome your recent announcement that there will be no further cuts to the welfare system and hope that the Autumn Statement will reflect this position. The welfare reforms already announced by the UK Government will result in benefit expenditure in Scotland being further reduced by around £1 billion per year by 2019-20.

The reversal of changes to tax credits announced in last year's Autumn Statement was a relief to many Scottish citizens, and I would urge you to use this year's Autumn Statement to re-consider the changes to the work allowances in Universal Credit which result in similar levels of hardship for families.

I also ask you to reverse the reduction in the benefit cap which has just come into force and which will plunge a further significant number of households – many with children – into financial difficulties in the run up to Christmas. A recent CIH report estimated that up to 20,000 children in Scotland could be affected.

Further, I request that you reconsider the ongoing freeze to working age benefits since the impact of this on households will be greater than initially estimated due to an expectation of faster increases in the rate of inflation. As a result of the freeze, the Resolution Foundation has estimated that *'a single earning couple with two children is set to be made £720 a year worse off in 2020 – with £225 of this coming purely as a result of inflation rising more rapidly than was expected when the policy was introduced.'*²

Finally, I hope the engagement between our two governments with regard to the devolution of benefits under the Scotland Act 2016 continues and would like to reiterate my expectation that you will ensure early engagement with me on any changes being considered to the benefits transferring to Scotland. I am also very concerned about the impacts on social security that might be experienced as a result of the UK leaving the EU and hope that Scotland will be fully engaged in meaningful discussions around this.

Scottish Police Authority and Scottish Fire and Rescue Service VAT

I have raised on numerous occasions the issue with regards to the inability of the Scottish Police Authority and the Scottish Fire and Rescue Service to reclaim VAT – which results in an additional cost to these bodies of around £30 million per annum. My colleague, the Deputy First Minister and Cabinet Secretary for Education and Skills wrote to the Chief Secretary to the Treasury on 24 February 2016 and 17 March 2016 on this issue and we are still awaiting a response to those two letters.

² <http://www.resolutionfoundation.org/wp-content/uploads/2016/11/Under-new-management.pdf>

The issue has been highlighted again with the Emergency Services Mobile Communications Programme, a major collaborative procurement initiative to facilitate interoperable communications across all of the emergency services within the UK. HMRC recently confirmed that the VAT on the contract is recoverable for all Crown Bodies under the HM Treasury contracted-out direction. This will see all emergency services across Great Britain, with the exception of the Scottish Police and Fire Services, recovering the VAT element of the contract. Financially this will see an additional cost to the Scottish taxpayer of £50 million in VAT over the lifetime of this programme to implement a critical GB-wide emergency services communications system.

Your officials have always maintained that the reason for the refusal to allow the services to reclaim VAT was because of the way Police and Fire services are funded in Scotland, and in particular the fact that they do not have a power of precept on local taxation. In practice, police and fire services in Scotland provide exactly the same services as in other parts of the UK, and it is very difficult for people in Scotland to understand why an extra cost burden should be placed on emergency services here. It is also difficult to understand why the Police Service of Northern Ireland, whose funding comes predominantly from the UK Treasury, is able to reclaim VAT under section 99 of the VAT Act while Scottish emergency services, which particularly from 2017-18 will be funded increasingly by Scottish taxpayers, cannot.

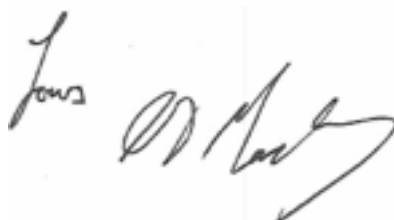
This disparity of treatment places a significant financial burden on Scotland, and in my view is not defensible by reference to objective criteria. We all realise that where there is a will there is a way, and the UK Government have highlighted this in recent years through legislative changes to allow VAT to be reclaimed by successor bodies following UK Government policy changes such as introducing Academy Schools and establishing Highways England. The existing position feels quite unfair. I therefore urge you to reconsider introducing changes to VAT legislation through the Finance Bill that would enable our Scottish emergency services to recover VAT.

Major new initiatives on fiscal matters

If there is an intention to announce major new initiatives on reserved tax or spending lines that impact devolved administrations at the Autumn Statement and future fiscal events, I would welcome early consultation before any announcements are made, or at least before policies are firmed up, to provide adequate opportunity for us to reflect the outcome of those decisions in our own financial considerations.

Furthermore, Autumn Statement 2016 must not compound the difficulties of Autumn Statement 2015 and Budget 2016 where new UK wide levies were announced with absolutely no prior discussion with the Devolved Administrations despite clearly impacting on areas of devolved policy.

I trust that you will consider the issues I have outlined above, and that you will reflect them in your Autumn Statement on 23rd November.

A handwritten signature in black ink, appearing to read 'James Murray', is written over a light blue horizontal line.

DEREK MACKAY