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Dear Mr Leonard,

Administration of Scottish Income Tax 2023-24

My thanks to you and members of the Public Audit Committee for the level of engagement at the session on Wednesday 26 March 2025 to discuss the administration of Scottish Income Tax.

During the evidence session, I and Jonathan Athow of HMRC understood to provide the Committee with the following information:

1. **Aggregate value of the tax gains or losses when comparing inward taxpayers with the outward taxpayers** (in response to Colin Beattie's question column 5)
2. **Self-assessment:** How the potential £29m reduction to the Scottish budget will be accounted for (in response to Graham Simpson's question column 19)
3. **Failure of employers to apply S Codes:** Further clarity on the size of companies failing to apply s codes correctly, reasons for the failures, whether improvements are being made and what software is associated with the problem. (in response to Graham Simpson's question, column 21).
4. **Reconciliations:** total number recorded in Scotland (in response to Graham Simpson's question column 23)
5. **The impact of relative tax policy and economic performance on the Scottish budget for SIT (AGS report pages 19-23):** Further clarity on figures within Exhibit 3 (AGS report p20) specifically on the £3.36 billion of additional tax paid due to tax policy differences and the £629 million figure of net position increase to the Scottish budget.

Further information on these points is set out below. This response has been prepared in collaboration with HMRC.

1. Aggregate value of the tax gains or losses when comparing inward taxpayers with the outward taxpayers

HMRC have provided the following response.

"HMRC's 2024 paper titled "[Intra-UK migration of individuals: movements in numbers and income](#)" used HMRC's new devolved longitudinal dataset to track the taxable incomes

(including both the devolved non-savings non-dividend income and the reserved savings and dividend income) and locations of UK taxpayers over a 12-year period. The dataset did not include the actual tax liability of each individual.

The analysis looked at the trends in the number of individuals moving between Scotland, Wales, and the rest of the UK (rUK) between the 2009/10 and 2021/22 tax years and includes inflows, outflows, and net movements. The analysis also considered the amount of taxable income migrating individuals earned in the year of migration.

Only people who had taxable income (including those with income below the Personal Allowance who therefore did not have any Income Tax liability) in two consecutive tax years are included in the estimates for migration between those two tax years. As such, these statistics do not aim to show the level of total migration between Scotland, Wales and rUK.

The net income movement to Scotland (the amount of taxable income earned by individuals migrating from rUK to Scotland minus the amount of income earned by individuals migrating from Scotland to rUK) was at a deficit between tax year ending 2011 and year ending 2019, averaging around -£60 million, and increased thereafter towards a surplus of around £200 million.”

In addition to the information provided by HMRC, the Scottish Government would make the following observation. Since the five band system of Scottish Income Tax was introduced in 2018-19, net migration has been positive across all tax bands with the exception of the Higher Rate in years 2018-19 and 2019-20, for which net migration was slightly negative. Looking since the devolution of Scottish income tax, calculations using the longitudinal data suggest that migration has overall made a positive contribution to tax receipts.

2. Self-assessment

The Committee identified the issue of double counting which came to light during HMRC routine quality assurance checks, revealing that a number of individuals were recorded in both the self-assessment and PAYE data extracts used during the production of the 2022-23 outturn statistics. Corrections were made to all preceding outturn figures in the July 2024 SIT outturn publication, with the NAO estimating that the Scottish Government received £29m more than it would have had the issue not been present from 2017-18 to 2021-22.

At the Committee session, Mr Simpson asked whether any decisions had been made on how to account for the potential £29m reduction to the Scottish budget.

Discussions are still ongoing with HM Treasury to agree the treatment of these historic outturn issues. Matters of this nature would ordinarily be discussed at bi-lateral meetings in the margins of the Finance Interministerial Standing Committee (F:ISC). There is currently no scheduled date for the next F:ISC meeting, which would be the earliest opportunity to progress this issue with the UK Government. On that basis, I will undertake to write to the Committee when a treatment has been agreed between the two parties.

3. Failure of employers to apply S Codes

HMRC have provided the following response.

When HMRC wrote to the Committee on 11 March 2025, we were in the early stages of contacting employers who are failing to correctly apply the Scottish ‘S’ codes issued to them by HMRC. Our Employer Education Team has continued to do this, prioritising employers

who are making the most errors and who are repeatedly failing to get this right. This outreach focuses on helping employers identify why these errors are happening and fixing them so the correct codes are applied. It will also help HMRC to understand why this is happening and if there is anything else we can do to support employers.

We are expecting further insights from this outreach to employers in May. We are happy to write to the Committee when these are available to update you on this, and on our ongoing work to gather more data about the errors being made.

4. Reconciliations

HMRC have provided the following response.

The end of year reconciliation process checks that customers have paid the correct amount of tax under PAYE. Every customer who has a record with HMRC will undergo the end of year reconciliation process resulting in the record either being balanced or the customer having paid the wrong amount of tax.

If the reconciliation shows that a customer has not paid the right amount of tax, we will send a P800 tax calculation between June and March of the following year to correct the record. The calculation will show if the customer is due a refund or if they owe more tax.

Over or underpayments of tax happen for a number of reasons, including tax code errors, job changes, starting to receive pension income, or receiving certain benefits. Tax code errors includes cases where Scottish taxpayers have paid the wrong amount of tax due to their employer failing to operate a Scottish 'S' code. Some taxpayers impacted by 'S' code errors still pay the right amount of tax, and in some instances the tax will be corrected in-year and there will be no over or underpayment of tax at the end of the year.

We do not monitor the number of individuals who are due a refund or owe more tax after the reconciliation process so we are unable to provide the number of Scottish reconciliations where over or underpayments of tax have occurred.

5. The impact of relative tax policy and economic performance on the Scottish budget for SIT (AGS report pages 19-23)

During the session, we discussed the difference between the amount of revenue raised by Income Tax policy divergence and the net position for Income Tax with reference in particular to the Audit Scotland Report "Administration of Scottish income tax 2023/24". You indicated that this would be an area the Committee would be interested in following up, and so I thought it might be useful for me to provide some additional background to our discussion.

Exhibit 3 in the Audit Scotland report sets out the estimate is of the amount of revenue raised by policy divergence with the rest of the UK between 2017-18 and 2022-23. This estimate is then compared to the net position, with the difference between these numbers attributed to an 'economic performance gap'.

As I set out at Committee, it is worth unpacking the factors that make up this calculation. There are three factors to consider in understanding the gap presented by the Audit Scotland report that I set out in my answer to the Committee, the point being that not all of the factors are attributable to current economic performance.

(i) Impact of taxpayer behaviour change

The estimate of revenue deriving from policy divergence contained in Exhibit 3 does not include any adjustment for behaviour change. The estimate is therefore a notional high point of the *possible* revenue that could derive from policy decisions taken by Scottish Ministers. In practice, behaviour change is considered by the Scottish Fiscal Commission in all their policy costings which are used to set the Scottish Budget each year.

Accounting for behaviour change by taxpayers when estimating the actual additional revenue raised by policy divergence would reduce the gap presented in the Audit Scotland report.

The Scottish Fiscal Commission has not made an estimate of the behavioural response to the cumulative policy divergence between Scotland and the rest of the UK.

As I said at committee, it is post-behavioural revenue that feeds into Scottish Government budgets, and that represents the amount of Income Tax that could be raised by policy.

The next two factors to consider relate to the operation of the fiscal framework to adjust the Block Grant.

(ii) Distributional factors

The Scottish Government has previously published analysis setting out how existing differences in the income distribution between Scotland and the rest of the UK pose risks to the Scottish Budget.¹ This analysis showed how even if we have the same pattern of earnings growth, differences in the composition of the tax base can mean that tax per head growth is not equal, and can result in a reduced net position.

This is as a result of structural differences in the economy. Due to the progressive nature of the Income Tax system, the performance of very high earners can have a disproportionate effect on tax revenues. At Committee I pointed to the impact financial services play in this regard, with the rest of the UK's financial services sector containing significant numbers of very high earners in areas like investment management and financial trading. This contrasts with Scotland's financial services sector where pensions and insurance is more prominent. Scotland also has a larger share of employment in the public sector compared to the rest of the UK.

This is becoming a more important factor to understand the trends affecting the net position over time. The underlying distributional differences pre-date devolution and reflect the make-up of the economy across the UK. Again, accounting for this in the analysis would explain a portion of the gap presented.

(iii) Additional factors

Finally, there are a range of other factors that will also contribute to the gap.

These factors include periods of differential earnings growth in Scotland and the rest of the UK. The Scottish Government has previously published analysis to better inform

¹ See Annex A: Income Tax – Distributional Risks to the Scottish Budget: [The Scottish Government's Medium Term Financial Strategy - gov.scot](#)

understanding of this topic.² This analysis set out the extent to which slower earnings growth in Scotland could be explained by the downturn in the oil and gas industry and economy in the North East of Scotland.

It should be noted this analysis only covered the period up to 2021-22. More recent data shows earnings growth in Scotland outpaced the rest of the UK in both 2022-23 and 2023-24, based on HMRC's PAYE Real Time Information data. The Scottish Fiscal Commission also currently forecast higher earnings growth in Scotland compared to the OBR's forecast for the rest of the UK over the next five years.

It is intended that further analysis examining this topic will be included in the next Medium Term Financial Strategy, setting out the contribution of behavioural, distributional and residual factors in explaining the gap observed by Audit Scotland. Initial results of this analysis have been included in the Annex of this letter. I would be happy to provide a written update to the Committee following publication of this material if helpful.

I trust this information is helpful to the Committee's work. I would be happy to follow up with any further information required.

Yours sincerely,

Alyson Stafford
DG Scottish Exchequer

² See Annex A: Regional and Sectoral trends across the Scottish and rUK Income Tax bases: [Scotland's Fiscal Outlook: The Scottish Government's Medium-Term Financial Strategy - gov.scot](#)

Annex

Table 1 below presents Scottish Government analysis which provides further decomposition of the gap observed in Exhibit 3 of the Audit Scotland report, as described above. This is based on figures at the end of December 2024. Further analysis on the decomposition of the gap and some of its elements is intended for publication as part of the Medium Term Financial Strategy.

Table 1: Breakdown of Exhibit 3 into components

| £M | 17/18 | 18/19 | 19/20 | 20/21 | 21/22 | 22/23 | Total |
|------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Tax policy differences | 121 | 386 | 618 | 637 | 747 | 877 | 3,386 |
| Behavioral impacts | -19 | -78 | -113 | -116 | -135 | -159 | -619 |
| Distributional impacts | -53 | -96 | -86 | -100 | -350 | -320 | -1,006 |
| Other impacts | -141 | -85 | -265 | -324 | -177 | -137 | -1,128 |
| Net Position | -91 | 127 | 155 | 96 | 85 | 260 | 632 |