THE ROYAL SOCIETY OF EDINBURGH

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INDEPENDENT COMMISSION FOR COMPETITIVE AND FAIR TAXATION IN SCOTLAND CALL FOR EVIDENCE

Response from The Royal Society of Edinburgh

Executive Summary

- *The proposed devolution of extensive new tax powers to Holyrood represents a unique opportunity for Scotland to take a refreshed approach to taxation. The Scottish Government must prioritise making the tax system fair, efficient and transparent.*
- *The decision to devolve the various tax and welfare powers by the Smith Commission was made without any clear set of guiding principles and at a speed which has not been conducive to thorough consideration, analysis and scrutiny.*
- *The Tax Commission's call for evidence is lacking questions surrounding welfare and productivity which are linked to taxation. It is important these issues are also considered as part of a broader discussion.*
- *Uncertainty around fiscal systems generally has a negative effect on business and consumer confidence. Any long-term fiscal uncertainty for Scotland could be highly damaging to its economy.*
- *The Scottish Government must take action to improve its financial reporting to make it more comprehensive and transparent. Constructing Whole of Government Accounts for Scotland, as are in place for the UK, would provide a clear picture of the overall assets and liabilities for the Scottish Government and how these are changing over time.*
- *The system of Council Tax is deeply flawed and provides a smaller share of government revenue year on year. Business Rates now provide more revenue for the Scottish Government than Council Tax. However, Non Domestic Rates are increasingly being earmarked to fund capital expenditure through systems that lack transparency.*
- *Scotland's proportionately lower-earning tax base puts it in a more challenging position than the UK as a whole in raising revenue from Income Tax. The Scottish Government has a responsibility not to shrink its tax base through its actions, although the mobility of this tax base is highly uncertain.*
- *As long as Scotland remains part of a monetary union within the United Kingdom there will be limits to the amount it can borrow.*

Introduction

1 The Royal Society of Edinburgh (RSE) is Scotland's National Academy, established in 1783 by Royal Charter and also a Scottish Charity. As part of its Royal Charter, the RSE is committed to the *Advancement of Learning and Useful Knowledge*. The RSE seeks to fulfil this Charter requirement in many ways, including providing advice on public policy issues to government, parliaments and public bodies. We are also willing to produce expert comment for any inquiries that we regard as significant to Scotland's economy and society. This advice is always offered on a non-partisan basis and is based on the expertise and knowledge of our diverse Fellowship.

2 The Royal Society of Edinburgh welcomes the opportunity to contribute to the work being undertaken by the Independent Commission for Competitive and Fair Taxation in Scotland. The RSE would also like to remind the Commission of the previous work it has undertaken around the devolution settlement[1], Scotland's fiscal framework[2] and the Scottish Fiscal Commission[3] which it may find useful in its examination.

Key Principles

3 The RSE considers that the devolution of such extensive tax powers to the Scottish Parliament, as was suggested by the Smith Commission, presents a unique opportunity for Scotland to take a refreshed and fairer, more transparent and efficient approach to taxation.

1 https://www.royalsoced.org.uk/cms/files/advice-papers/2015/AP15_02.pdf
2 https://www.royalsoced.org.uk/cms/files/advice-papers/2015/AP15_04.pdf
3 https://www.royalsoced.org.uk/cms/files/advice-papers/2015/AP15_10.pdf

4 Adam Smith, a founding member of the Royal Society of Edinburgh, first laid out the principals of fair taxation. These have had their most recent expression in the Mirrlees *Review on Reforming the Tax System for the 21st Century* published in 2011[4]. The review stressed that in a 'good' tax system:

- The negative effects of the tax system on welfare and economic efficiency should be minimised;
- Administration and compliance costs should be low – a system that costs less is preferable;
- Fairness (in a non-distributional sense) is achieved – for example, fairness of procedure, avoidance of discrimination, and fairness with respect to legitimate expectations;
- Transparency is vital – it is always preferable that taxpayers understand the system.

5 The Scottish Government must prioritise making the tax system fair, efficient and transparent.

General Comments

6 Despite this significant opportunity for Scotland to improve its system of taxation, the RSE is concerned that the decision to devolve various tax and welfare powers to Holyrood was made without any clear set of guiding principles and at a speed which has left little time for thoughtful consideration, analysis and scrutiny. In order to most effectively underpin sustainable economic growth and promote greater productivity, it may be that Scotland would wish for a different set of powers than those that are to be delivered.

7 While the RSE is pleased to provide evidence to the Commission, we note the absence of questions in the call for evidence surrounding areas such as welfare and productivity which we think are intrinsically linked to taxation. Policies that stimulate economic growth may serve to reduce inequality, generate more tax revenue and reduce dependence on welfare. It is important that a broader discussion takes place and not one that focusses narrowly on issues such as tax rates.

8 Guiding principles are equally important when addressing welfare. One of the main reasons for having a social insurance system is to share risks across a nation-state and it is surprising that no explanation was given by the Smith Commission over its decision to deconstruct the system.

9 As more tax powers are devolved to Scotland, the Scottish Government's tax revenues will be subject to much more macroeconomic risk than has previously been the case. The desire to smooth macroeconomic fluctuations will have implications for borrowing powers. This represents an important future policy issue.

10 The RSE notes that uncertainty around fiscal systems generally has a negative effect on business and consumer confidence. Individuals and businesses act on the basis of expectations, even if these expectations turn out to be unfulfilled. It is important that a level of certainty is established over the fiscal environment. While the UK Government policy of legislating against certain tax rises in the current Parliamentary session is unusual, and some would argue unnecessarily constraining, it at least provides clarity to business over the direction that headline tax rates will take.

11 For Scotland, any long-term fiscal uncertainty could prove corrosive. Those considering investing, or taking up employment, in the Scottish economy will demand, at the very least, to be aware of the principles and direction of the Scottish fiscal regime. It is important to stress that such uncertainty, which could prove negative for investment in Scotland, is also created by the impending referendum on UK membership of the EU.

12 The RSE is encouraged by the Scottish Government's focus on employability, rather than simply focussing on welfare. It is vital that employability and skills are high on the national agenda. Addressing these issues should also serve to improve Scotland's productivity which continues to lag behind that of the rest of the UK by around 2% – and hence lags even further behind most competitor nations.

13 The Scottish Government needs to take action to improve the transparency in and comprehensiveness of financial reporting. At present, while the UK has Whole of Government Accounts (WGA), there is no equivalent balance sheet for Scotland's public finances. Thus there is no picture of overall assets and liabilities of the Scottish Government and how they are changing over time. Given the extension to its fiscal powers, it is important that the Scottish Government construct such accounts at the earliest opportunity. These would provide a much better basis for accountability, for making decisions about how the new powers should be used, and for involving the public in debate over the choices involved. They could also serve not only to feed into the budget process, but also to inform Scotland's borrowing strategy.

4 http://www.ifs.org.uk/publications/mirrleesreview/

14 A 2013 report by the Auditor General, *Developing Financial Reporting in Scotland*[5], stressed that comprehensive, transparent and robustly scrutinised public financial reporting would become increasingly important as the Scotland Act 2012 was implemented and that the Scottish Government needed to improve this. With the considerable further powers to be devolved following the Smith recommendations, this will become even more important. The Scottish Government may wish to consider the example of New Zealand in this area. The PwC Global Survey on Accounting and Reporting by Central Governments found that New Zealand *"has been at the forefront of government accounting developments, having implemented accrual accounts two decades ago…"*.[6]

15 It is of vital importance that the powers devolved to Scotland under the Scotland Act 2012 and the Scotland Bill currently travelling through Westminster are utilised by the Scottish Government. There has been inertia over the powers already under the remit of the Scottish Government; powers over reform of local taxation and limited powers over income tax have not been exercised to the extent available.

Local Taxation

16 The RSE is of the view that the Council Tax system has fallen into disrepute. The Council Tax freeze that has been in place over the last eight years means that this tax is providing a proportionately smaller share of revenues and is thus decreasing as a means of holding local authorities accountable to the local electorate. Furthermore, the freeze has proved regressive: wealthier households continue to contribute a lower proportion of their incomes than poorer households that are not eligible for full council tax benefit. Both the system and the structure of Council Tax are flawed.

17 It is not necessary that more tax should be collected at a local level. Tax could be collected nationally and assigned to councils according to population share in a method similar to that proposed by the Smith Commission for assigning VAT receipts to Scotland. Such a system works well in Germany where each level of government is assigned a proportion of revenues collected in the area, without extensive controls over local tax rates. However, this does raise questions over accountability. Clearly there is a higher level of accountability if tax rates are set locally, as those responsible for spending can be held responsible for their decisions on tax rates.

18 Business Rates now provide more revenue for the Scottish Government than Council Tax, with around a third more revenue coming from Non Domestic Rates. However, future Non Domestic Rates are increasingly being earmarked to fund capital expenditure by the use of Tax Incremental Financing (TIF) where the Scottish Government advances local authorities money based on future business tax revenues. The Growth Accelerator Model (GAM) will divert a portion of future income streams to repay the initial infrastructure funding for major projects. The impact of these systems lacks transparency due to the uncertainty over the extent of commitment of future business tax revenues.

19 Devising any sort of new local tax in Scotland could prove difficult. Mobility of labour, especially in the Central Belt, is such that significant numbers of people commute between local authorities and different cities on a daily basis. Extensive commuting raises serious issues around the effects on local taxation and accountability of taxation at place of work or at place of residence. The issues surrounding the introduction of a Local Income Tax have been widely discussed, including by the Burt Report in 2006 which dismissed the idea in part due to the immense *"practical problems"*[7] of applying such a tax.

20 It should be noted again, that local taxation is an area over which Scotland has had power since before the Scotland Act 2012, yet no action has been taken to solve these longstanding problems. While studies and inquiries into local government financing, such as the aforementioned Burt Report, Lyons Inquiry (2007)[8] and current Scottish Government Commission on Local Tax Reform[9], have and are being undertaken these have led to little discernible action.

5 http://www.audit-scotland.gov.uk/docs/central/2013/nr_130704_financial_reporting.pdf
6 https://www.pwc.se/sv_SE/se/offentlig-sektor/assets/towards-a-new-era-in-government-accounting-and-reporting.pdf
7 http://www.gov.scot/Resource/Doc/153766/0041377.pdf
8 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/229035/9780119898552.pdf
9 http://localtaxcommission.scot/

Income Tax

21 The make-up of the tax base for income tax in Scotland is noticeably different from that of the UK as a whole. The proportion of people in Scotland paying the basic rate of income tax is higher than the proportion of the population of Scotland relative to the UK, but for those who pay the higher rate and additional rate, it is lower. This comparative lack of high earners is a challenge for the Scottish Government.

22 While there may be a political incentive to target high earners through an increased top rate of income tax or Land and Building Transaction Tax there should be a high level of caution exercised by the Scottish Government not to shrink its tax base. High income (and generally high value-adding) individuals will have a greater level of national and international mobility than others and the possibility of them relocating to other parts of the UK exists. Of equal concern would be the possibility that in doing so they would take business, clients and staff with them. It is, however, important to note the huge uncertainty over how mobile the Scottish tax base is.

23 Issues around distortion of income tax are also a problem which the Scottish Government will have to address. Currently there is distortion at the intensive margin (people working fewer hours) and distortion at the extensive margin (people dropping out of the labour market). The devolution of income tax now means that the possibility of migration in response to tax differences and converting income into dividends must also be considered.

24 In addressing income tax rates, it is in many ways more important to consider how flat or 'saw-toothed' the tax system should be (whether there should be a lower or higher number of progressive tax bands), rather than focussing on individual rates. Currently, the UK has three tax bands and if Scotland chose to mirror this system, but with an increase in the additional rate, it would raise very little extra revenue. Rather, if Scotland sought to increase the money available to it for welfare services it would need to increase rates right through the middle of the distribution. A multiplicity of rates in which taxpayers move into higher bands more rapidly is one option available to the Scottish Government. But equally careful consideration should be given to the relative merits of moving to a flatter set of income tax rates.

Other Taxes

25 A decision by the Scottish Government to cut or abolish Air Passenger Duty (APD) would, in the short run, act primarily to increase the profits of airports and airlines, given that our major airports seem close to capacity. Furthermore, this could lead to significant distortions in the patterns of air travel. We are not convinced that these 'downsides' have been adequately considered.

Borrowing Powers

26 As long as Scotland is part of a monetary union as part of the UK then there will be limits to the amount it can borrow. Until we know what limits are to be enforced by the Scotland Act 2015 it is very difficult to comment further.

27 It has been suggested that something similar to the Prudential Code may provide an appropriate framework for the Scottish Government to control the future borrowing it may be permitted to undertake. The Prudential Code was introduced in 2004 to support local councils and control decisions over capital investment, including borrowing. Thus, this is the only area in which the public sector in Scotland has an established experience of borrowing.

28 However, the RSE is strongly of the opinion that a system similar to the Prudential Code would not be sufficient for long-term planning for government. A March 2015 report by the Accounts Commission[10] found that local councils used the code to the minimum to meet requirements, producing short-term budgets with a short-term view of projecting the impact of borrowing. This leads to future problems as more and more income is spoken for in interest payments and repayments. The report also stressed the need for more detailed and longer-term planning and budgeting for borrowing and treasury management. The Prudential Code is not an adequate guide for the macroeconomic management of the public finances.

29 While the Scottish Government currently does not have borrowing powers, it does have long-term commitments around public finance initiatives (PFI), non-profit distribution (NPD) and other forms of revenue finance investment (e.g. regulatory asset base (RAB) charges that support the expansion of Scotland's rail network). There is currently a significant lack of transparency surrounding such arrangements. These issues would be encompassed within an exercise to produce a set of Whole of Government Accounts for Scotland (see para 12).

10 http://www.audit-scotland.gov.uk/docs/local/2015/nr_150319_borrowing_treasury_management.pdf

Appendix – Questionnaire

Question 1 – In your opinion, what are the three most significant public policy challenges facing Scotland at the moment?

The RSE considers that fundamentally, the public policy challenges facing Scotland are no different from those facing other countries. Three of the most pertinent are:

- How to design a system of taxation and welfare that satisfies the fundamental principles of efficiency (the avoidance of poverty traps and the promotion of productivity), fairness and transparency.
- How to deliver public services in a way that is both fair and efficient.
- How to administer these systems effectively.

However, Scotland also faces some specific challenges, including dealing with the above issues in the context of a UK system where the basic assignment of tax and spending powers has not been designed with any discernible overarching system of coherent principles. Westminster must be permitted to set the overall macroeconomic framework for the UK, yet the UK and Scottish Governments have taken sharply opposing views on issues such as austerity. How such vast policy differences can be resolved and to what extent the Scottish Government can pursue a different approach to welfare are also highly uncertain.

The problem of inertia in the Scottish political system is also troubling. Holyrood has had significant powers over some areas, for example local taxation, for some time and could have implemented significant reforms, yet has chosen not to do so.

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 policy agenda compared to the rest of the UK?

Yes. However, as noted in our response to question 1, Scotland already had significant powers pre-Smith and has chosen not to utilise them fully. It is also important to note that the UK government is unlikely to extend powers to Scotland in a way that might threaten its own macroeconomic stability. In particular, it would be concerned if Scotland used such powers to adopt a substantially different fiscal strategy.

Question 3 – Should the overall burden of taxation in Scotland be lower/higher/the same as in other parts of the UK?

Simply, the level of tax raised –along with the available borrowing – must be enough to pay for public services.

Due, in part, to the lack of young migrants moving to Scotland in comparison to other parts of the UK, Scotland faces a more challenging demographic situation than other parts of the Union. Scotland's population is aging more rapidly with the proportion of the population that is of pensionable age expected to increase by 2.9 % between 2010 and 2035, compared to a 1.7% rise in the UK as a whole[11]. This situation, coupled with the health issues faced by Scotland, means that if the same level and quality of public service was to be provided for all citizens across the UK (based on the same delivery approaches), higher public spending in Scotland would be necessary.

Question 4 – Is tax competition between different parts of the United Kingdom to be welcomed or avoided?

Firstly, it is important to state that tax competition is neither unambiguously positive nor unambiguously negative. Such competition may force a region to lower a tax rate that is too high or too distortionary, but can also lead to a race to the bottom.

Tax competition is virtually inevitable if control over tax rates is devolved to sub-national regions and those regions choose to set different rates.

Tax competition can have both active and passive manifestations. The active manifestation sees a lower tax rate chosen in order to attract economic activity to a region or to counter the loss of activity to regions outside of the UK. The passive manifestation sees tax rates kept at the same rate as elsewhere out of fear of tax competition.

It should also be noted that such competition within the UK may be driven by factors outside of the United Kingdom. An example of this would be proposed lower rate of corporation tax in Northern Ireland. This is being driven by corporation tax rates in the Republic of Ireland, but in turn creates tax competition with Scotland.

The most salient factor in this discussion is the degree of mobility of resources between regions. It is important to stress how little is known about the relevant responses (described by economists as elasticities).

It is also important to highlight that what is often perceived as tax competition is actually political competition. The recent one-upmanship between the Scottish and UK Government over Land and Buildings Transaction Tax and Stamp Duty Land Tax falls into the category of the latter as the location of the citizen determined the tax they would pay.

11 http://www.scottish.parliament.uk/S4_FinanceCommittee/Inquiries/National_Records_of_Scotland.pdf

Question 5 – Should the public spending model in Scotland be different to that in other parts of the UK?

There is no reason that the Scottish Government should be obliged to follow the same spending pattern as the UK Government as, within the context of the block grant, it has the right to make its own decisions. However, both governments face significant challenges and have vastly different views on the policy that is needed to meet these challenges. To achieve a workable situation between the two governments some form of mechanism must be developed for agreeing fiscal policy.

Question 6 – Should a larger or smaller share of total revenue collected in Scotland be collected through local taxation?

See paragraphs 16 – 20 in main text.

Question 7 – Does the Scottish system of local taxation as a whole need to be reformed? If so, how?

See paragraphs 16 – 20 in main text.

Question 8 – If you think that Council Tax should be replaced by a different form of local taxation, what principles would you adopt in devising a new system?

See paragraphs 16 – 20 in main text.

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)?

See paragraphs 16 – 20 in main text.

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?

See paragraphs 16 – 20 in main text.

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)?

See paragraphs 16 – 20 in main text.

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?

See paragraphs 21 – 24 in main text.

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?

See paragraphs 21 – 24 in main text.

Question 14 – Should Income Tax in Scotland mirror the structure and level of Income Tax in the rest of the UK?

See paragraphs 21 – 24 in main text.

Question 15 – If not, do you have any suggestions as to the rates, bands or thresholds of Scottish Income Tax?

See paragraphs 21 – 24 in main text.

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?

Question 17 – Do you have any comments on the proposed devolution/assignment of Air Passenger Duty, Aggregates Levy and VAT pursuant to the Bill?

See paragraph 25 in main text.

Question 18 – The Christie Commission presented a case for radical public service reform. Do you agree and if so, why?

Question 19 – Can you identify specific areas for reform? What would be the potential financial impact of such reform?

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?

Question 22 – What principles and limits would you apply to borrowing powers, present or future on conclusion of the Smith Agreement negotiations?

See paragraphs 26 – 29 in main text.

Additional Information

Consultation responses are produced on behalf of RSE Council by an appropriately diverse working group in whose expertise and judgement the Council has confidence. This Advice Paper has been signed off by the General Secretary.

Any enquiries about this response should be addressed to Craig Denham, Policy Advice Officer, cdenham@royalsoced.org.uk.

Responses are published on the RSE website **www.royalsoced.org.uk**

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