

A Scottish approach to taxation: call for evidence by the Scottish Parliament, Finance Committee

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Further to the call for evidence issued by the Scottish Parliament's Finance Committee about the possible development of a Scottish approach to taxation - "A Scottish Approach to Taxation: call for evidence" - this paper provides some views about specific issues which have been raised, by assuming the four taxation principles as yardsticks also in all responses from the third to the sixth one (and particular attention is paid to the ability to pay principle).

1. The modalities to achieve the Scottish Government's four principles to underpin Scottish taxation policy.

The principles of ability to pay, certainty for the taxpayers, convenience/easy of payment and efficiency, can be achieved at the level of each individual tax *or* at the level of the taxation system as a whole. To attain this second objective, it would be necessary to achieve the principles at the level of each of the most important taxes, i.e. at the level of each of the taxes that determine the higher onus from taxpayers' perspectives. In other words, either each of the taxes is individually shaped according to these principles, or the each of the most important taxes is modelled in such a way as to comply with these principles. In any case, the achievement of these principles is important in combining fairness and attractiveness of the taxation system for any jurisdiction which intends being open to internationally mobile individuals and businesses.

The *ability to pay principle* - which has a long history in legal documents¹ - actually inspires the taxation systems of most countries at worldwide level, and is expressly embodied in national Constitutions² or well settled in the case-law of a number of countries. At the outset, applying this principle requires identifying the indicators of ability to pay. In many countries, these indicators consist of income and of other increases in a taxpayer's wealth. The principle at issue can be achieved in two ways, which both ends up making the taxpayer pay a higher proportion of its overall income the wealthier he is.

One way - which is the most typical one and which applies, in particular, to income tax - consists of progressive income tax brackets, such as those already in existence for the purpose of the current personal income tax. The presence of a tax-free allowance is an important part of the implementation of the ability to pay principle, coupled with other reliefs of fixed amounts to take into account specific circumstances of taxpayer's situation. *Another way* consists of a flat tax rate, coupled with higher deductions, from the tax base, for lower income earners. *A combination of these two modalities* can also be observed in a number of countries, especially for personal income tax purposes, with regard to deductions tailored to the personal situation of the taxpayers (i.e., some countries set progressive personal income tax brackets, coupled with higher deductions for lower income earners).

¹ In fact, the first expression of this principle in a legal document can be found in Art. 13 of the 1789 Declaration of the Rights of Man and of the Citizens issued in revolutionary France.

² E.g., Art. 31 of the Spanish Constitution; Art. 53 of the Italian Constitution; Art. 127 of the Swiss Constitution.

To achieve the ability to pay principle, at least the *most important* taxes – i.e., the taxes which generate the higher revenues and which are perceived by taxpayers as being the most onerous ones – should be shaped in one of the manners just referred to, or in a combination of both. In fact, any tax which is not shaped according to either of these modalities, is in contrast with the ability-to-pay principle. A taxation policy aimed at generating overall tax burdens, for any taxpayers, which are proportionate to the ability to pay, should therefore limit the *number and kinds* of taxes which have flat rates without deductions, or which are set in fixed amounts (those taxes should only be the less important ones).

Certainty for taxpayers can be provided firstly by writing tax provisions in a clear and unequivocal language, which does not leave scope for different interpretations, and, secondly, by introducing a general system of “*advance tax rulings*” available to taxpayers both before they undertake transactions which involve tax implications and before they meet tax compliance requirements. Specifically: taxpayers who feel unsure about the tax consequences or the tax burden deriving from specific transactions, or who feel unsure about the proper tax compliance, should have the possibility of asking a binding ruling to the tax authority about how the tax provisions apply in their concrete situation. This possibility already exists in a number of both EU and extra-EU countries and it plays an important role in providing legal certainty to taxpayers³. The “*advance tax rulings system*” should ideally exist for all taxes which are not automatically collected, i.e. whose collection mechanisms require the submission of tax returns, and it should lead to advance rulings which remain binding on the tax administration until the relevant tax provisions – whose application is at stake – remain in force.

When submitting the request for a tax ruling, the taxpayer should be allowed to propose his/her own interpretation and solution, and – in case of failure by the tax authority to respond within a fixed term (e.g., 30 days) – the silence should be taken to indicate a legally binding consent of the tax authority to the interpretation and the solution given by the taxpayers. Such a system is already applied in some jurisdictions, but the timing for response by tax authorities is usually longer than 30 days. Therefore, the introduction of such an advance ruling system would on the one hand act as an incentive for the tax administration to quickly respond to taxpayers’ queries and boost legal certainty for taxpayers, and it would, on the other hand, contribute to the procedural “*attractiveness*” of the Scottish tax system from an international comparative perspective.

Convenience/easy of payment can be achieved by allowing facilitations in the payment – eg., deferral of payments, payment by instalments – for those taxpayers who face difficult financial situations. It can also be achieved – at the level of the system as a whole – by allowing tax liabilities for one tax to be offset against any tax excess (i.e., against any expected tax refund) for another tax.

Efficiency can be achieved, for each tax, through modalities of tax assessment and collection ensuring that the related costs remain lower than the additional revenue that a new tax would generate. The higher the difference between the revenue generated by each tax and the assessment and collection costs, the higher the efficiency of each tax and, in consequence, of the tax system (the efficiency is also enhanced by taxpayers’ care in properly meeting their tax obligations).

2. The current taxation regime and the proposals for newly devolved taxes vs. the four taxation principles

³ As regards “*advance tax rulings*” in EU member states, see: European Parliament, Directorate-General for Internal Policies, “*Tax Rulings*” in the EU Member States, 2015.

The current taxation regimes is – on its whole – roughly consistent with the four principles, but there is scope for improvement. In particular, whereas the principles of convenience/easy of payment and of efficiency can be seen as already complied with due to the modality of payments, with regard to the principles of ability to pay and of legal certainty the assessment below applies.

The *Land and Business Transaction Tax* (LBTT) – due to its progressive price brackets – is consistent with the ability to pay principle as regards its rates and bands for residential property transactions and, to a minor extent, to its rates and bands for non-residential property transactions, and for lease of non-residential property. As regards non-residential property transactions, to the extent that a higher purchase price reflects a higher ability to pay, subjecting to a 3% rate both a £. 350.000 purchase and a £. 150.001 purchase implies an equal treatment of different ability-to-pay. It would thus be more consistent, with this principle, to set another, intermediate price bracket, e.g. to set a 2% tax rate for purchase prices above £. 150.000 to £. 250.000. The additional dwelling supplement, due to its flat rate above the exemption threshold, appear to be in contrast with the ability-to-pay as it does not imply a higher proportion of tax for a higher price of the additional dwelling.

The LBTT could, in my view, be made more consistent with the ability-to-pay principle if the tax – instead of being paid only by the purchaser – were to be paid 50% by the purchaser and 50% by the seller. In fact, the transaction does not determine an increase in the ability to pay of the purchaser alone; it also increases the financial resources available to the seller. Especially in case of sale of properties which are (not used as main dwelling and which are) not occupied by tenants, the owner's ability to pay does not benefit from the mere possession of properties (which may even imply some expenses, e.g. restructuring or maintenance, and thus reduce the ability-to-pay), but it would certainly benefit from the sale.

The *Scottish Landfill Tax* (SLfT), as a tax on the disposal of waste to landfill charged by weight on the basis of two rates - a standard rate for active materials; and a lower rate for less polluting (referred to as 'inert') materials – can be seen as an effective “environmental tax”, i.e. as a tax aimed at penalizing waste-producing activities which are damaging to the environment, but it does not bear a relation with the ability-to-pay principle. To link this tax, as it currently stands, with the ability-to-pay principle, it would be necessary to collect evidence showing that the wealthier taxpayer tend to dispose a greater quantity (implying a greater weight) of active materials waste than poorer taxpayers. Without such an empirical evidence, this tax, if hitting poorer taxpayers more than wealthier taxpayer due to the mere disposal of active material weight, turns out being even a regressive one, in contrast with the ability to pay principle.

Consistency with the principle of legal certainty could be enhanced through the introduction of a system of advance rulings, as suggested in 1 above, at least for the LBTT and for the SLfT.

The *Air Passenger Duty* (APD) as it currently stands - therefore, with its reduced, standard and higher rate structure – could be regarded as consistent with the ability to pay principle *provided that* higher-income taxpayer normally use premium class (attracting the standard rate of tax), and lower income taxpayer normally use economy class (subject to reduced rate of tax). However, without empirical evidence that this is actually the case, the tax could be at odd with the ability-to-pay principle: in case of two taxpayers earning the same income but using the two different classes (which may happen for various circumstances, not necessarily linked to personal preferences), the different amount of APD paid would be inconsistent with “horizontal equity”, one of the cornerstones of the ability to pay principle (horizontal equity means that two taxpayers earning the same income should be treated in the same way in terms of tax liability).

The *Aggregate Levy* is an effective environmental tax and, due to its taxable event, it falls on businesses carrying out specific activities involving the extraction and use of sand, gravel and rock. As the amount of payment depends on the quantity of extracted tonnes, the tax can be regarded as related to the ability to pay to the extent that a higher quantity of tonnes implies a higher scale activity resulting in higher profits.

The *Scottish Rate of Income Tax* (SRIT), as it currently stands - due to its allowing the persistence, for Scottish taxpayers, of the same overall income tax brackets applying in England & Welsh - can be regarded as “neutral” from the ability-to-pay viewpoint. It does not make the overall income tax structure more consistent in Scotland with this principle, than the same structure is in the rest of the UK. Nonetheless, when the Scottish Government will be able - as a result of the further devolution of powers that has been agreed - to set its own tax brackets and rates for non savings and non dividend income (NSND), the overall income tax structure could be made more consistent with the ability-to-pay of Scottish resident taxpayers. This could be done, theoretically, either by creating one more income tax bracket at the top (e.g., a 45% income tax bracket for incomes from £. 150.000 to £. 350.000, and a 50% tax rate for incomes over £. 350.000) or by granting more personal deductions – i.e., more deductions linked to taxpayers’ personal circumstances – to taxpayers in the 20% income bracket than to taxpayers in the 40% and 45% brackets. As the first option (i.e., increasing the top income tax rate) has already been considered as involving a significant policy risk of highest earners leaving Scotland⁴, only the second route would seem to be feasible, but it would require that the power to decide tax reliefs be also devolved to the Scottish Parliament.

The assigned VAT can also be regarded as “neutral” from the ability-to-pay viewpoint, as it cannot lead to a greater consistency with this principle than the VAT is in the UK. Generally speaking, VAT is based, in all countries, on the assumption that consumption is also a signal of ability-to-pay. Consistently with this assumption, necessary goods – which are consumed by everyone to fulfil basic needs – are generally subject to reduced tax rates, rather than to the standard tax rate.

Lastly, the reforms which have already been announced by the Scottish Government to the *Council Tax* system⁵ are certainly able to make this local tax more consistent with the ability-to-pay principle, particular with regard to the stated goal of changing how the rate for more expensive properties in bands E-G is calculated and asking people in these bands to pay more. An even greater consistency with the ability-to-pay could be achieved by linking the discount for single person households to the income of those households, i.e. by making it inversely proportional to the income through the introduction of brackets of discount: e.g., a single person household earning a 300.000 £. annual income could – from the ability-to-pay viewpoint – be treated differently from a single person household earning 45.000 £. annual income; the 25% discount could be granted to the latter, not to the former. The Council Tax reduction for low income earners is also consistent with the ability-to-pay principle.

3.The scope for a fundamentally different approach to taxation in Scotland

In considering whether there is scope for a fundamentally different approach to taxation in Scotland, the overriding concerns should be to avoid risks of shifting of the taxable base outside the country, a risk which, by definition, would also contravene the four taxation principles.

⁴ The Scottish Government, *The impact of an increase in the additional rate of income tax from 45p to 50p Scotland*, March 2016, at p. 4

⁵ <http://www.gov.scot/Topics/Government/local-government/17999/counciltax>

The need to ensure stability of the tax base is closely related to both behavioural responses – and thus to the need not to induce taxpayers to move to other parts of the UK - and the nature of the taxable base. Because immovable property already falls within the scope of the LBTT, and because the most mobile tax base, i.e. financial assets and income therewith, is outside the scope of the devolved and assigned taxes, the only potential change that could be considered for a fundamentally different approach would be a replacement of the LBTT with a general Property Value Tax.

The Commission on Local Tax Reform, in its 2015 Report, already considered positively the case for a progressive property tax, as a substitute for the Council Tax⁶, but it also pointed out divergent views, among public opinion, as to whether a property tax relates to ability to pay and, therefore, as to whether property should be taxed. As regards the idea of replacing the Council Tax, that idea may be set aside as the Council Tax finds its justification in the “benefit principle” and thus in the benefits that local services bring to a property occupier, and as the reform announced by the Scottish Government would bring the Council Tax more in line with the ability-to-pay too. Therefore, a consideration of a fundamentally different approach to taxation would need to examine a Property Value Tax as a substitute for the LBTT. In my view, to the extent that a property was bought out of personal financial resources deriving from incomes that had *already* been taxed, the property in itself only represents an investment of after-tax earnings and thus it does not indicate new ability-to-pay if/when its value does not increase after purchase. Nonetheless, the increase in the market value of a property – from one year to another - certainly indicates additional ability to pay. Accordingly, a general Property Value Tax could be conceived as a tax on the increases in value of the overall portfolio of land and buildings (intended as flats, houses, etc..) owned by a taxpayer during any given tax year. Conversely, a reduction in the market value of a property during a given tax year should be regarded as a reduction in the ability to pay, and the owner should be allowed, at least, to offset it against future increases (just as it occurs, in several jurisdictions, with the carry-forward of losses of one tax year to future tax years). More specifically, this option would appear to be suitable for high income earners owning only one property, since for them the reduction in the value of the property would reduce the ability to pay to a lesser extent than for low or medium income earners owning only one property, for whom a different solution will be proposed below in section 5.

In the event of a taxpayer owning several properties, some of which increasing in value and some other decreasing in value during the same tax year, the taxable base of a Property Value Tax should be determined by offsetting the increases and the decreases against each other. That design of the tax base, together with a progressive tax structure above values exceeding a minimum exemption threshold, would ensure consistency with the ability to pay principle.

However, the introduction of such a tax would require a yearly assessment of the market value of properties, and would thus involve costs and administrative complexity. Moreover, to avoid juridical double taxation (i.e., double taxation of the same value in the hands of the same taxpayer at local level and at Scottish Government level), a choice of introducing such a Property Value Tax would require: *a)* either the value of the owner’s self-occupied property, subject to Council tax, to be deductible in the determination of the taxable base of the Property Value Tax, or *b)* the amount of the Council Tax be deductible from the amount of the Property Value Tax.

⁶ The Commission for Local Tax Reform, Volume 1 – Just Change: A New Approach to Local Taxation, December 2015, para. 11.11 and 11.12

Conclusively, in assessing the merit of the introduction of such a tax, which would mark a fundamentally different approach to taxation, the additional revenue it would bring about would – necessarily - have to be assessed against the costs of introducing a system of annual assessment of market value of properties. This costs-benefits assessment would be necessary for consistency with the efficiency principle.

4. Ring-fencing future tax changes

“Ring-fencing” taxes, if considered through the prism of the taxation principles, could arguably be intended in three meanings: whether tax from particular sources should be earmarked for specific expenditures (the most common meaning); whether a limit should be put on the overall tax liability; whether and whether tax changes should remain in force for a specific period.

In the first meaning, it would be appropriate to ring-fence future tax changes (for all each period when each tax change remains in force) to give taxpayers a clear indication about the destination of their (changing) contributions to the public expenses, to the benefit of the perception of transparency in the overall public finances administration system. This should apply in particular to the taxes which are most well known to the majority of taxpayers, such as the LBTT, the SLfT and, when the power to establish income tax brackets and rates will be exercised, the income tax too, to the possible extent. In this sense, in my view ring-fencing could increase the general perception of accountability and thus have a positive effect in terms of efficiency of tax collection (thanks to a possible increase in taxpayers’ own perceived duty of care in submitting returns and making tax payment).

In the second potential meaning, it would be appropriate to ring-fence future tax changes to make sure that changes would never go beyond compliance with the ability to pay principle, which, in itself, already constitutes a limit to the taxing power. In this sense, it would be appropriate to ring-fence future tax increases, e.g. by always maintaining exemption thresholds.

In the third possible meaning, future tax changes should be ring-fenced for reasons of longer-term legal certainty for taxpayers, and the ring-fencing could be implemented simply by stating in the law, at the time of introduction of a tax provision either introducing a new tax *or* changing an existing tax regime, that the change will remain in force for a given number of year (e.g., for a 5 year period). Such a choice could be made for the most significant taxes, such as the LBTT and the SLfT, whereas it would be appropriate not to make it for other taxes, to allow margin for tax changes in response to any new and expected circumstance creating new budgetary needs or budgetary surpluses.

5. Behavioural responses and options for tax changes

The available statistics about behavioural responses, which suggest that the tendency to change their behaviour in response to tax changes can be particularly large for high earners, have already been taken into consideration by the Scottish Government when assessing the impact of an increase in the additional rate of income tax from 45 to 50 per cent in Scotland, and when concluding that such a change would bring a high risk to revenues⁷. In light of the need to ensure that the taxable base could not be switched outside Scotland or, at least, to minimize this risk, the only option for a tax change, that could be considered, would arguably be the introduction of a Property Value Tax as

⁷ The Scottish Government, The impact of an increase in the additional rate of income tax from 45p to 50p Scotland, March 2016, at p. 4

highlighted in 3 above, provided there were estimate showing revenues significantly exceeding the administration costs. To enhance the consistency of such an option with the ability to pay principle, when the Scottish Government has the power to establish both income tax rates and bands, in case of taxpayers owning only one property of a value exceeding the minimum threshold and earning low or medium incomes, any reduction in the value of the property during a tax year could be taken into account as a relief for income tax purposes for the same tax year. For these taxpayers, in fact, the reduction in the value of their only property can be taking as adversely affecting their ability to pay to a higher extent than for high income earners.

6. The administration of the Scottish tax system via HMRC vs. the scope for a different tax system in Scotland

In terms of tax policy choices, i.e. of choices concerning the kind of taxes and their structure as regards tax base and tax rates, the mechanisms for administering the Scottish income tax system via HMRC, do not limit the scope for development of a different tax system in Scotland, *provided that* the collection and management of any different tax by HMRC were as effective and efficient as it would be the collection and management of the same tax by Revenue Scotland or by a newly set-up Scottish tax authority having as its purpose only the collection of taxes for the Scottish Government. The effectiveness of HMRC's collection and repayment of the Scottish Rate of Income Tax (SRIT) to the Scottish Government could be subject to an assessment, after the first two years, as such assessment could offer useful indications. In fact, if the *expectations of the Scottish Government* in terms of effective working of the mechanism are fulfilled, there would be ground for relying on HMRC for the collection and payment to the Scottish Government of any new different tax too, but this would not be the case if those expectations are not fulfilled. Moreover, if the development of a different taxation system in Scotland is to be driven by the four principles of ability-to-pay, certainty, convenience/ease of payment and efficiency, HMRC's past records in collecting personal income tax, corporate income tax and other taxes falling within its remit, makes it possible to draw indications as to whether administration by HMRC would create a limit to consistency of a Scottish tax system with these four principles.

Whereas the principles of certainty, convenience/easy of payment and of efficiency, appear to be consistent with HMRC's newly introduced practices such as the introduction of "digital tax accounts" or well-settled practices such as the PAYE system and the adjustment of the tax code for collection purposes, the principles of ability to pay may be at odd with a policy of granting tax amnesties. More specifically, the principle of ability to pay would have to be complied with in *each individual tax year*, i.e. in each tax year taxpayers would ideally need to contribute to public expenditure according to their overall economic capacity of so doing. For this reason, a practice of granting tax amnesties to specific categories of taxpayers for failure to meet their tax liabilities in one or more past tax years – i.e. of allowing these categories of taxpayers to retrospectively regularise their tax affairs with reduced penalties - does not appear to be fully consistent with the ability-to-pay principle, particularly if tax amnesties are granted to high earners taxpayers and if the past frequency of tax amnesties makes these taxpayers reliant on future tax amnesties.

In other words, to the extent that some high earners (in particular, self- employed individuals and businesses) are in a position to carry out a cost-benefits analysis in a trade-off between timely compliance of their tax obligation for the tax year and a later compliance with reduced penalties thanks to expected tax amnesties, it is possible that, in specific tax year, the distribution of the tax onus among taxpayer is not consistent with the ability-to-pay principle. On the other hand, the practice of granting tax amnesties has often been driven – in other countries too – by a pressure of raising revenues, especially at times of difficult macroeconomic conditions.

7. Any other administrative limitation to the emergence of a Scottish Tax System

In my view, there are no other administrative limitations to the emergence of a Scottish Tax System; by contrast, the setting up and the start of working of Revenue Scotland, as a tax authority with distinctive responsibility for devolved taxes, can be seen as a first administrative step toward a Scottish taxation system.