Finance Committee
Scottish Parliament
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27 September 2016

Dear Finance Committee members,

Inquiry on a Scottish approach to taxation

Reform Scotland is delighted to respond to the committee's call for evidence as part of its Inquiry on a Scottish approach to taxation. We have tried to answer the issues highlighted in the call for evidence.

Few powers

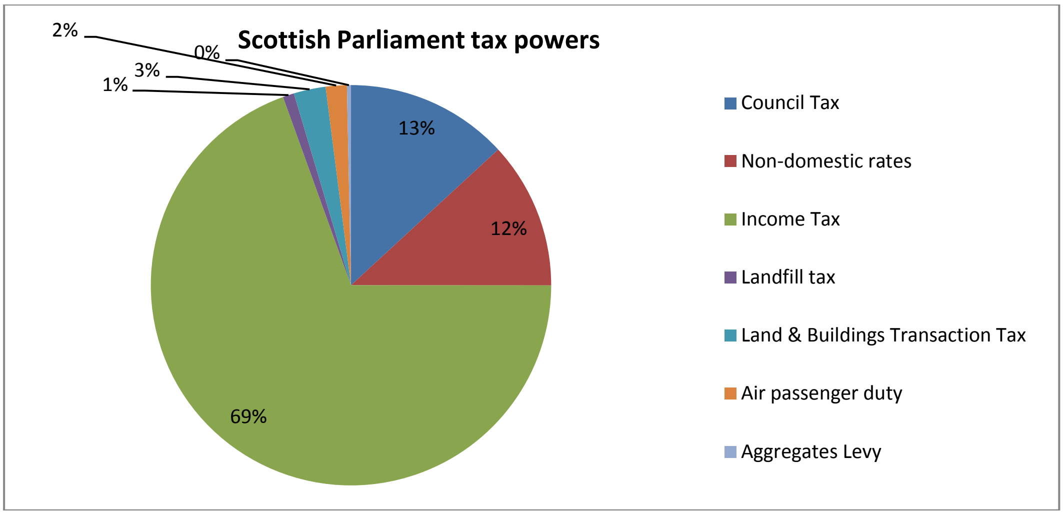
Although the new powers due to be devolved to Scotland under the Scotland Act 2016 are to be welcomed, it is important not to overstate the opportunities they bring.

While the rates and bands of income tax are being devolved, income tax on dividends and savings, as well as control over the personal allowance, remain at Westminster. In other words, the tax as a whole is not being devolved and it therefore makes sense for HMRC to continue administering the tax.

Reform Scotland would suggest that it is not HMRC administrating the tax which could "*limit the scope for a different tax system in Scotland*" but the fact that the tax is not fully being devolved in the first place. The fact that the Scottish Parliament is only being given greater control over one major tax also limits the potential for reform.

While we welcome the decision to devolve Air Passenger Duty and Aggregates Levy, these are two very minor taxes and together represent only 0.61% of all tax income raised in Scotland.

With only one major tax, there is very little scope for reforming the tax system in Scotland. Based on GERS 2015/16, 69% of all tax revenue raised by the Scottish Parliament will be from a single source, as illustrated in the pie-chart below. This over reliance on Income Tax offers little scope to effect real reform and so limits the opportunity to create a better environment for economic growth. Indeed, until the Scottish Parliament has control of a varied basket of taxes, we would urge the Scottish Government to peg Income Tax to the UK rate.



Source: GERS 2015-16.

Further tax powers

As a result, Reform Scotland believes that the only way to enable the Scottish Government to create a different approach to tax, or to reform the system, is with the devolution of further taxes. We have continually argued that the Scottish Parliament should be responsible for raising the majority of what it spends and believe far more tax powers can, and should, be devolved.

VAT

While we appreciate that another Scotland Bill to devolve greater powers is unlikely to happen in the short term, we would argue that there is a case for VAT now to be devolved in full. We did not include VAT in the figures highlighted above because 50% of VAT receipts are simply assigned to the Scottish Parliament and so it is still a reserved tax controlled at Westminster. Some VAT revenues were assigned to Scotland because it would give the Scottish Government an incentive to find ways to increase those revenues, but the ability to vary the rate could not be devolved because it was not allowed under EU law.

With the UK voting to leave the EU, there is no reason why the UK Government cannot give a commitment to devolve VAT in full once we have formally left the EU. David Gauke, Chief Secretary to the Treasury, told the House of Commons on 9th December 2015 that "*The Smith commission set the objective that more devolved spending in Scotland should come from tax raised in Scotland. Control over setting VAT rates is not being devolved to Scotland, because EU VAT law does not allow for differential VAT rates within a member state*"

By assigning VAT revenue the UK Government recognised the benefit another tax would bring to the Scottish Parliament. However, without control over that tax, there is no ability for the Scottish Government to look at reform and encourage economic growth. If the argument has been accepted that VAT is a useful tax for Scotland to have, but it could not be devolved due to EU law, once the UK leaves the EU there is no reason why it could not be devolved in full.

Devolution of VAT in full would also enable the Scottish Government to directly address a number of issues regarding the application of VAT in Scotland, especially with regard to Police Scotland.

If VAT was devolved, there would be a broader basket of tax powers, as illustrated below, enabling some elements of reform to be considered. While it would not go as far as Reform Scotland would like, it should certainly be the next step.

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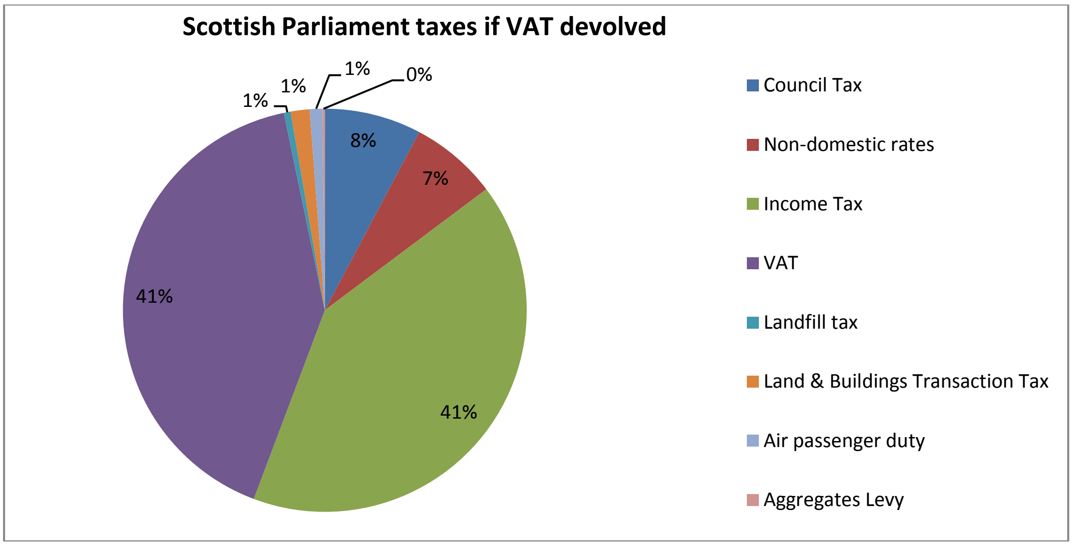

It would also mean that the Scottish Parliament would go from being responsible for raising 37% of the money it spends, to 63%.

Corporation Tax

Following the passing of the Corporation Tax (Northern Ireland) Act 2015, which devolves some elements of Corporation Tax to Northern Ireland, the case for devolution to Scotland should be re-examined. Although the tax hasn't been devolved in full to the Assembly, with control over the base, reliefs and allowances remaining in Westminster, the very fact that some elements of the tax have been devolved to one part of the UK clearly shows it is possible to devolve the tax. As we have mentioned, we appreciate that the Scotland Act is not going to be re-opened in the short-term. However, we would urge the UK and Scottish Governments to look at the Northern Irish situation and see what could be agreed for Scotland in the future.

Behavioural responses

The call for evidence asks whether potential behavioural responses limit options for tax changes in Scotland. Reform Scotland has not carried out work into what the behavioural changes could be. We believe, as stated earlier, that the main constraint on changing and/or reforming tax in Scotland is that we only have control over part of one of the major taxes.

However, we would certainly argue against tax changes that could result in behavioural changes which then lead to a lower tax take. For example, there has been debate over whether to increase the top rate of tax in Scotland. Given the ease with which Additional Rate tax payers could switch earnings to savings and dividends, which Scotland doesn't control, or change their residency, there is a real danger that increasing the top rate of tax becomes a symbolic gesture which actually ends up raising less money, as well as potentially putting off investors and entrepreneurs from coming to Scotland. Should that be the case, how will the shortfall be filled? As the Scottish Government has limited options, it could mean lower rates of tax having to increase, with lower earners paying for a largely symbolic gesture.

One of the four principles of the Scottish Government's taxation policy is that it should be "efficient". Increases in higher rates of tax which lead to lower tax takes, or deter inward investment, are not efficient.

Administration

There are two issues Reform Scotland wants to touch on under administration – the need for a single tax and welfare department, and devolving power beyond Holyrood.

Single department

Although the committee isn't considering welfare powers as part of this inquiry, it does mention the administration of tax as one area it is examining. Reform Scotland believes that there should be one Scottish department, under one Cabinet Secretary, responsible for both the new tax and welfare powers due to be devolved to Scotland. This may at first seem like a small administrative point, but it is about looking to create a better, more coherent and transparent system and not simply replicating what happens at Westminster.

At Westminster there is the Department for Work and Pensions (DWP) and Her Majesty's Revenue & Customs (HMRC). The former is responsible for welfare and the latter for taxation. However, it is not that simple; child benefit has switched to being an HMRC responsibility along with tax credits, though both of those benefits interact with others that lie with the DWP. Figures on benefit expenditure are often opaque where two departments are involved and produce different figures. As a result, the two departments make for a less transparent and efficient system for the taxpayer.

There are clear overlaps in their roles. So instead of simply following the Westminster model, there is an opportunity to look to see if Scotland can do things differently. Surely we can come up with a better system and this at least should be considered.

Although, as highlighted earlier, HMRC will currently continue to administer Income Tax for Scotland, there may come a point in the future, particularly if more powers are devolved, when Revenue Scotland takes on this role. It is also necessary to create a department now which can easily adapt to increased responsibilities in the future. Therefore, we would recommend that groundwork is undertaken now to ensure that Revenue Scotland can easily adapt to new powers in the future. It is worth remembering that if Scotland creates two separate departments, some individuals will find themselves having to deal with four different departments in order to receive their welfare entitlements. This is not efficient and certainly not in the interests of the individual user. Therefore, Scotland has an opportunity to lead Westminster by example and create a more user-friendly and efficient system.

Localism

Reform Scotland believes that there should be an attitude towards taxation in Scotland that supports devolution of tax beyond Holyrood where appropriate. This recognises that communities across Scotland are different with differing needs and priorities. Therefore, there needs to be a balance between central and local government with a presumption in favour of power being exercised as close to those affected as possible. Power is, in our view, too centralised at present and the top-down, uniform approach this encourages has failed to deliver adequate social and economic progress. This is why decentralising reform, which empowers local communities and people, is the best way forward.

Fiscal autonomy and control over revenue-raising powers are essential to this process of enhancing local accountability and ensuring services are more responsive to the needs and preferences of local people. Currently, local councillors have no real control over local taxation so have little room for manoeuvre. Reform Scotland, therefore, would like to see Council Tax and Non-Domestic Rates being fully devolved to local authorities so that they would have the ability to take local priorities and circumstances more fully into account. This would also allow individual councils to choose the structure of local tax most appropriate for their area.

We are disappointed that the Scottish Government has not taken the opportunity to give local authorities more control over their own taxation. While we are pleased that the council tax freeze has ended, we would prefer to see local authorities given the ability to make their own decisions about bandings and to whom and how their own local tax applies, rather than the Scottish Government deciding on these things.

However well intentioned it is to increase funding on education to close the attainment gap, the decision to do this by the Scottish Government taking money from the new council tax bands to then re-distribute is wrong. This policy would end the link between local taxation and local people. Council Tax is supposed to be a local tax that is raised by local politicians, accountable to their electorate, to pay for services in their area. This is a vital part of local democracy and should not be weakened.

Conclusion

Finally, new powers which bring the Scottish Parliament closer to raising the money it spends are always welcome. However, when those powers are insufficient to affect real reform we must be extremely careful how we use them, otherwise we risk doing harm.

Yours sincerely,

Geoff Mawdsley
Director
Reform Scotland