



Advice Paper 16-21

September 2016

A Scottish Approach to Taxation

Response from the Royal Society of Edinburgh

Introduction

1. The Royal Society of Edinburgh (RSE) welcomes the opportunity to submit evidence to the inquiry being undertaken by the Scottish Parliament's Finance Committee into *A Scottish Approach to Taxation*.
2. Through the Scotland Act 2012, the Scottish Parliament gained the ability to raise or lower Income Tax equally across all tax bands by 10p in the pound. It also gained competency over what was then Stamp Duty and Landfill Tax.¹ The subsequent Scotland Act 2016 extended Holyrood's remit to give it the power to set rates and bands on non-savings and non-dividend income, in addition to devolving control of other taxes such as Air Passenger Duty and Aggregates Levy. From April 2017 the Scottish Government will be assigned half of the VAT receipts estimated as arising in Scotland.²
3. Over the past several years, the RSE has actively and consistently engaged with government, parliament and other interested bodies around issues of fiscal responsibility, taxation and the devolution of powers. In doing so, we have produced various Advice Papers to which we would draw the attention of the Committee:
Air Passenger Duty (June 2016)³
The Scottish Fiscal Commission (November 2016)⁴
Competitive and Fair Taxation in Scotland (July 2015)⁵
Scotland's Fiscal Framework (April 2015)⁶
4. This response was prepared using the expertise of a Working Group of RSE Fellows from a wide range of institutions and with diverse backgrounds. The Advice Paper has been approved by the General Secretary of the Royal Society of Edinburgh.

¹ http://www.legislation.gov.uk/ukpga/2012/11/pdfs/ukpga_20120011_en.pdf

² http://www.legislation.gov.uk/ukpga/2016/11/pdfs/ukpga_20160011_en.pdf

³ https://www.royalsoced.org.uk/cms/files/advice-papers/2016/AP16_13.pdf

⁴ https://www.royalsoced.org.uk/cms/files/advice-papers/2015/AP15_23.pdf

⁵ https://www.royalsoced.org.uk/cms/files/advice-papers/2015/AP15_12.pdf

⁶ https://www.royalsoced.org.uk/cms/files/advice-papers/2015/AP15_04.pdf

Principles of Taxation

5. The call for evidence highlights the four principles the Scottish Government has stated will underpin its approach to taxation policy, namely that the system should:
 - *Be proportionate to the ability to pay;*
 - *Provide certainty to the taxpayer;*
 - *Provide convenience / ease of payment, and;*
 - *Be efficient.*
6. Of these four principles, *proportionality*, *certainty*, and *efficiency* relate to the design of a tax system, while *convenience / ease of payment* relates to operation of the system.
7. The RSE notes that there have been many previous formulations of the principles that should underlie a good tax system. Adam Smith, a founding member of the Royal Society of Edinburgh, first laid out such principles which had their most recent expression in the Mirrlees Review on *Reforming the Tax System for the 21st Century* published in 2011.⁷ 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.
8. The Committee is undoubtedly aware of the extensive literature on best practice for the design of a tax system, including the Mirrlees Review. The RSE would strongly recommend that such resources be utilised in the design and reform of the Scottish tax system.

Proportionality

9. The principle of proportionality would seem to go beyond the principles proposed by Mirrlees in that it introduces an element of distributional fairness. The RSE supports the idea of incorporating distributional fairness as a principle. However, we note that ‘ability to pay’ is an ambiguous concept, one which can be interpreted to be based upon either income or wealth.
10. Proportionality might mean simply that those with greater ability to pay should pay more tax, and there is a risk that a narrow reading of proportionality would suggest a system in which everyone pays in tax the same fraction of their ability to pay (a ‘flat tax’). This narrow sense of proportionality would be inconsistent with a more commonly supported principle of progressivity, whereby those with greater ability to pay, pay a higher proportion of income, or other measure of ability to pay, in tax.

⁷ <http://www.ifs.org.uk/publications/mirrleesreview/>

11. The RSE recommends that the Scottish Government should simply adopt a commitment to distributional fairness, rather than an explicit principle of proportionality.

Certainty

12. Certainty to the taxpayer is undoubtedly important, and relates to the wider Mirrleesian principle of lowering compliance costs. Uncertainty, and the costs of resolving the problems that arise from it, contributes to compliance costs. The Mirrlees principles of procedural fairness and transparency also address the issue of certainty. The RSE urges the Scottish Government to endorse these wider-ranging principles of low compliance costs, procedural fairness, and transparency.

Convenience / Ease of Payment

13. While the Scottish Government's principle of 'ease of payment' is certainly part of the Mirrlees principle of keeping the costs of compliance as low as possible, such costs are wider than those of payment. For example, they encompass the costs of understanding the requirements of compliance, and providing the information required to comply. The RSE again suggests that the Scottish Government adopt the wider-ranging principle of keeping compliance costs low.

Efficiency

14. The principle of efficiency stated by the Scottish Government relates to the suggestion by Mirrlees that a good tax system should minimise "the negative effects on welfare and economic efficiency".⁸ It should be noted that minimising the negative effects on welfare and economic efficiency can encompass the normal requirement to minimise the distortionary impact of taxes. It can include using the tax system to correct negative externalities that cannot be better handled by other policies, for example the Carrier Bag Charge; and reducing opportunities for tax avoidance. The RSE supports a principle of efficiency which encompasses all of these.
15. The Royal Society of Edinburgh believes that the Scottish Government should prioritise making the tax system fair, efficient, simple, transparent, sustainable and consistent with other government policies. It is our view that there is nothing uniquely Scottish in these core tenets, which should apply to any system of taxation, not just Scotland's.

Tax Reform in Scotland

16. Applying the universal principles for a good tax system to Scotland could, however, give rise to a reformed and distinctive Scottish tax system for several reasons:
 - Scotland has a different set of productive assets and opportunities than in other countries;
 - It will also have its own particular distribution of various socio-economic characteristics, such as age and health;

⁸ <http://www.ifs.org.uk/publications/mirrleesreview/>

- The distortionary costs of various types of taxes will differ from other countries, for example the mobility of highly-skilled labour;
 - The Scottish Government will have scope to make value-based and normative judgements on factors such as fairness, and environmental concerns.
17. However, the Scottish Government is not designing and implementing a completely new tax system. Rather, the starting point is the inherited, and inevitably imperfect, UK system. So there could be scope for developing a more distinctive Scottish tax system by undertaking reforms to the existing system that have not so far been undertaken by the Westminster Government.
 18. Moreover, under the devolved tax powers the Scottish tax system is entangled with that of the UK, so undertaking reforms within such a framework will inevitably lead to a distinctive Scottish tax system.
 19. It is important to distinguish between principles for the design of an entirely new tax system (as discussed above) and the practicalities of reforming the system which comes with the newly devolved powers of taxation.
 20. It is extremely difficult to reform a longstanding and ingrained structure, such as our model of taxation, through incremental steps. The significant institutional changes which have occurred over the last several years, and are scheduled to continue over the coming years, present the Scottish Government with a unique opportunity to effect real change in this area.
 21. The system from which we begin is far from ideal in many respects. Efficiency is one of the key principles espoused by the Scottish Government, and the efficiency of the Scottish tax system would be greatly aided by simplification. While the UK Government clearly recognises the importance of this - illustrated through the creation of the Office for Tax Simplification in 2010 - the UK system also contains over a thousand exemptions.⁹ Such loopholes not only provide scope for individuals to 'game the system' and avoid tax, but also raise questions of equity as these exemptions are often only available to those with the resources to access them. The RSE recommends that the Scottish Government endeavours to make the Scottish tax system as simple as possible, minimising loopholes.
 22. Reform of the tax system will need to take into account some inherent vulnerabilities in the system, and the base from which it draws. The make-up of the tax base for Income Tax in Scotland is noticeably different from that of the UK as a whole. In Scotland just 0.7% of taxpayers (17,000 individuals) pay the Additional Rate of Income Tax compared to 1.1% in the UK as a whole. In Scotland, these 17,000 people contribute 13.7% of total tax revenues.¹⁰ This comparative lack of high earners is a challenge for the Scottish Government.
 23. While there may be a political incentive to target high earners through an increased top rate of Income Tax or Land and Buildings Transaction Tax there should be a high level of caution

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https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/198570/ots_review_tax_reli_efs_final_report.pdf

¹⁰ <http://www.gov.scot/Resource/0049/00497818.pdf>

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. Of equal importance to the Scottish Government will be adequate enforcement by HMRC around Scottish residency rules in regards to taxation.

24. Issues around distortion of Income Tax are also a problem which the Scottish Government will have to address. Distortion may arise from people working fewer hours and from people leaving 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.
25. The Scottish Government must also carefully consider the implications of tax competition with the rest of the UK. 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 when control over tax rates is devolved to subnational regions and those regions choose to set different rates.
26. 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.
27. 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 the 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.
28. The increasingly intertwined and global nature of taxation means that tax bases are shared between countries, and between subnational regions, and that cooperation over tax rates and countering tax avoidance is increasingly important. The Scottish Government finds itself in the position of being a subnational actor embedded within a quasi-federal state. As mobility of the tax base is likely to be higher between regions of the same state, than between independent countries, the Scottish Government is incentivised to levy higher taxes on non-mobile areas such as land and property. We note that (aside from Capital Gains Tax on real property) the Scottish Government now has control over all property taxes, and has an opportunity to look at them in the round. Ideally, tax on property should move away from transactions to ownership, so as to incentivise the allocation of property to productive use.
29. It is understandable that the Scottish Government, or Local Authorities, would look to adopt methods to tax non-residents such as levies on the extraction of natural resources or on tourism. This clearly allows the government to raise extra revenue, without putting the burden on citizens they later rely on for re-election. While such taxes can prove effective, we stress the importance

that sustainability and room for growth of the potential tax base should be favoured over the opportunity to collect potentially short-term revenues with little political fallout. The RSE highlights Air Passenger Duty (APD) as an effective revenue raising tax – it also serves an important environmental function – which allows the Scottish Government to tax non-residents. We reiterate our position that the rate of APD in Scotland should not be reduced.

30. The RSE also notes that the Scottish attribution of VAT receipts from the UK Exchequer will not include revenues directly raised from tourism, with this being adjusted by estimating the proportion of UK tourism that is assigned to Scotland. It is unclear whether this estimate will take into account any action taken by the Scottish Government which boosts tourism. This incentivises the Scottish Government to examine something like a hotel tax in order to ensure it collects revenue from visitors. Furthermore, the attribution of VAT to Scotland will be based on a relatively small sample included in the Living Costs and Food Survey (LCF).¹¹ It is highly important that the data used are sufficiently robust.
31. Tax cooperation between the Scottish and UK governments will be of fundamental importance as a result of the extent to which they share tax bases. Scottish Income Tax payers will also pay National Insurance to the UK Exchequer, for example. The RSE considers that joint reform of the Income Tax and National Insurance systems is long overdue, and now can only be achieved if the Scottish and UK governments can effectively co-operate, and avoid the type of adversarial relationship we have seen develop in recent years. Both governments must work toward this.
32. The macroeconomic context of Scottish tax policy is a significant new factor that must be considered. The nature of the new fiscal settlement means that Scotland's tax revenues will now be very exposed to macroeconomic shocks. Revenues will also be exposed to macroeconomic trends that may cause long-term divergence between the UK and Scottish economies. In turn, the Scottish macroeconomy will be exposed to shocks that arise from, or are magnified by, the Scottish tax system. The RSE strongly urges the Scottish Government to develop its tax system on the basic principles of working to minimise the risks to Scotland's tax revenue of macroeconomic shocks and to minimise the impact of the tax system on macroeconomic stability.
33. The devolution of new tax powers takes place in the political climate of the UK decision to leave the European Union. This has created a great deal of political and financial uncertainty. The decision also opens up the possibility of variations in VAT and Corporation Tax within the UK – a situation which previously was prohibited or constrained under EU law. It is important that the Scottish Government takes action to make its tax base as large as possible, rather than allowing special exemptions.

Reform of Tax Policymaking

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<http://www.ons.gov.uk/surveys/informationforhouseholdsandindividuals/householdandindividualsurveys/livingcostsandfoodsurvey/lcf>

34. While the fundamental principles of a good tax system remain underlying, Scotland-specific opportunities and risks exist in reforming the system. However, the uncertainties surrounding tax competition and the increasing need for international tax cooperation mean that a Scottish tax system is unlikely to be radically different from that of the UK. Where there is substantial scope for change in Scotland is in the adoption of a different approach to developing tax policy.
35. Scotland has an opportunity to move away from the annual cycle of a set-piece UK Budget announcement controlled exclusively by the Chancellor of the Exchequer and UK Treasury. The minister with responsibility for taxation does not own the system, and indeed relies on the public for the raising of tax revenue. The Scottish Government has not committed to mirroring the annual Westminster Finance Bill. The RSE welcomes this. We recommend that the Scottish Government take this opportunity to develop a different, and more strategic, method for its process of making tax policy.
36. The RSE notes the model adopted by New Zealand as an illustration of best practice. The General Tax Policy Process (GTPP)¹² is a formalised multiphase process which follows five phases:
- Strategic phases: economic strategy; fiscal strategy; three-year revenue strategy.
 - Tactical phases: rolling three-year work programme; annual work and resource plan.
 - Operational phases: detailed policy design; formal detailed consultation and communication; ministerial and Cabinet signoff of detailed policy.
 - Legislative phases: drafting of legislation; ministerial and Cabinet signoff of legislation; introduction of bill; select committee phase; passage of legislation.
 - Implementation and review phases: implementation of legislation; post-implementation review; identification of remedial issues.
37. In addition to a more strategic process, the Scottish Government should take action to cultivate greater co-operation between levels of government and, within government, between individual departments. Clarity over roles and relationships is essential. Recent Scottish Government proposals to use the proceeds of a reformed Council Tax for a centralised Attainment Fund serve to cloud the roles of each level of government. The RSE stresses the importance of transparency and believes that clearly defined remits and responsibilities over which actors are taxing the public and spending public money are needed.
38. The Scottish Government could also take positive action in developing a more inclusive consultation process, which not only provides the public with opportunities to comment on specific policies, but welcomes their input around wider priorities. The RSE recognises that the Scottish Government has a good track record in consulting the public, but it must work to ensure that the information gathered, along with relevant research and the best available evidence base, is at the core of the development of policy.

¹² <https://www.ctf.ca/ctfweb/CMDownload.aspx?ContentKey=16c095f4-6be3-4be7-ad2c-c2e2f252e3d5&ContentItemKey=62ed6fc7-8151-4068-8084-7dcff99d8f1a>

39. A more inclusive consultation process would also serve to strengthen public confidence in the system and its institutions. Transparency over how public opinion has influenced the making of policy and clear communication over how much and why the public is being taxed should be fundamental to the system. Informed public consent must be at the centre of policymaking.

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).

All responses are published on the RSE website (www.royalsoced.org.uk).