

## Submission from Sandra Eden – A Scottish Approach to Taxation

Response to the consultation paper of the Finance Committee of the Scottish Parliament

1 Whilst the four canons identified by Adam Smith are plausibly attractive, it is not straightforward to incorporate them into a tax system. There are a number of reasons for this, one of which is that they do not always pull in the same direction.

The principle of taxation proportionate to ability to pay suggests that the position of the taxpayer is at the centre of tax design. Ability to pay is a slippery notion<sup>1</sup> but, however defined, suggests that the tax burden is tailored to characteristics of the taxpayer – income level obviously, but also married status perhaps, or children, or debt. Strictly interpreted, the demographics of smoking might suggest very low taxes on tobacco, whereas other considerations such as reducing demand for a damaging good or taxing an inelastic base suggest the opposite.

The other three principles identified, certainty, convenience and efficiency, generally suggest a different sort of tax system – a simpler system and one in which rates are flat (or flatter). Simplicity in a tax system has much to commend it. If reliefs are limited, fewer boundary disputes mean more certainty. If economically similar activities are taxed in similar ways, commercial choices are less distorted by tax driven decisions and are more efficient. Fewer quirks in a tax system result in fewer avoidance opportunities (and a reduction in anti-avoidance legislation immediately reduces complexity) and simultaneously accommodates ability to pay.<sup>2</sup>

Simple tax rules do not necessarily require flatter rates, although highly differentiated rates of income tax for example may mean value becomes more attractive, and lower rates of tax may be more efficient as they reduce incentives to disengage in economic activity (the substitution effect).

There are many examples of dividing lines in the tax system which generate incentives for tax driven behaviour – the difference between the taxation of income and capital gains, between the taxation of companies and unincorporated business, between earned income (subject to NICs) and investment income are just some. These examples relate to powers which are largely outwith the jurisdiction of the Scottish Parliament at present, but the point may become more relevant in the future.

I am not suggesting that the ability to pay should be ignored in the design of a tax system,<sup>3</sup> rather that there is a balance to be achieved between this and, generally, the other three principles. What I am suggesting is that the creation of reliefs and/or additional tax burdens must be based on clear

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<sup>1</sup> Is this judged at the level of each tax or the system as a whole? Is it judged at the level of the household or the individual, taken as a snapshot or across a lifetime? Is it judged by reference to income, or income and ownership of wealth, or by expenditure? Figures from the ONS show that that direct tax (largely income tax and NICs) is progressive whilst indirect taxation is regressive and that the combined effect is roughly proportional to income, when looked at across quintiles: ONS: *The effects of taxes and benefits on household income: financial year ending 2015*.

<sup>2</sup> It doesn't matter whether the taxpayer takes route A or B – the tax bill is the same.

<sup>3</sup> For example all the exemptions from the council tax would appear to be justified under either this principle or under the principle of convenience.

policy.<sup>4</sup> Tax can be a clumsy tool and should be used to create incentives and disincentives where other mechanisms cannot more effectively achieve similar policy ends.

Substantive tax changes should be evidence-based where possible, follow full consultation and be introduced after a proper period of consideration. The additional dwelling supplement in relation to LBTT is an example of rushed legislation which could have been improved by a longer lead time. And the Finance Committee needs no reminder of the difficulties created for the Scottish Government by the timing of the UK budgetary processes.

It is also important that the impact of tax changes is monitored – for example, will a lower rate of APD lead to an increase in the use of Scottish airports? At what point does an increase in the SLFT lead to an increase in illegal dumping?

Stability is another desirable feature of a tax system, relating to the principle of certainty. In arguing for stability, I am again not suggesting that the present tax system, parts of which are excessively complex, unfair or ineffective, should not be changed. I am arguing against fiddling. The changes over the last 15 years or so in relation to capital gain small business reliefs (retirement relief, taper relief, entrepreneurs' relief) provide an example of how not to do things.

Stability and simplicity go hand in hand. First, the simpler the tax system, the less there is the need to fine-tune or introduce anti-avoidance legislation. Second, change itself causes complexity.

It is suggested that a body similar to the OTS is created in Scotland in the longer term which will not only review existing tax policy, but also scrutinise new proposals. The 400 – 600 or so pages of legislation in each of the last few finance acts must be regarded as evidence of a broken tax system.<sup>5</sup>

2 I do not intend to comment specifically on the taxes which have been introduced by the Scottish Government, apart to note that the response to the 2015 report of the Commission on Local Tax Reform has been disappointing, especially in relation to revaluation, and that there does appear to have been a clear commitment to consultation.

3 In the longer term, there is scope for a fundamentally different approach to taxation in Scotland, but the relatively limited extent of unfettered tax power in the hands of the Scottish Government means that, for some time to come, the tax system is going to be largely dictated from Westminster. There is no point in having a specifically Scottish version of something which was formerly UK wide except where supported by clear policy. The SDLT slab system of tax on land transactions had long been criticised and the move to a graduated system in the LBTT was a demonstrable improvement on the previous system. However, I remain unconvinced that the specifically Scottish GAAR was necessary given that the operation of GAARs in practice is to a large extent determined by the attitude of the judiciary rather than the precise terminology of the GAAR

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<sup>4</sup> A recent example of an ill-thought through relief is the residence nil rate band for inheritance tax, to come into effect in 2017. The policy behind this is unclear, the legislation is enormously complex, the relief is likely to be economically distortive in favour of residential property ownership (the relief only applies to residences and not to other assets), and is likely to lead to the use of complex tax avoidance practices in relation to equalisation of the estates of spouses/civil partners which had more or less become unnecessary after 2007 when the standard nil rate band became transferable on death.

<sup>5</sup> *CIOT Shifting sands of UK tax policy and the tax base - CIOT comments* p 5, April 2016

itself. A small point in the context of the GAAR, but perhaps of more general importance in the future – taxes should not be given the kilt for the sake of it.

4 In relation to the question on ring-fencing, I assume that this relates to the earmarking of all or part of a tax source for a particular expenditure. The literature suggests that this is not a good idea. It may make a tax increase more palatable from a political perspective, but short term political gain is at the cost of the ability of governments to spend tax revenue where it is most needed at any particular time.

5 In relation to behavioural responses, the answer is that this is obviously potentially an issue. Should Scotland impose higher rates of income tax on the very highest income than in rUK, this is likely to affect the most mobile taxpayer and the risk of relocation is real. In my view, the Scottish government took a pragmatic approach in leaving it the additional rate of income tax at 45%. The number of additional rate taxpayers in Scotland is small but their tax contribution is significant. Whether or not a reduction in the higher rate of tax would attract high income individuals resident elsewhere is less clear.

However, apart from tax rates, the costs of compliance with separate tax regimes must also be taken into account. The view of many commentators is that corporation tax should remain at a UK level, as the administrative and compliance costs of operating even separate rates of tax (which means identifying “Scottish” profits), leaving aside separate corporate tax bases, are enormous. So as not to straddle two tax jurisdictions, it is not inconceivable that enterprises will shift their tax base into one, and Scotland will face risks here. Some taxes are less susceptible to this problem because of the nature of the tax base, for example the taxation of heritable property.

I have no comments on the administration of the Scottish tax system.

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