

A Scottish approach to taxation

Submission by Taxpayer Scotland

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A Scottish approach to taxation call for evidence

Preamble:

We are rather surprised to see that there is an expectation that there will be “a shift of focus from expenditure to consideration of revenue-raising”.

We rather hope there will be an integrated approach with equal weight on both the spending and taxation side. They are in no sense mutually exclusive.

Executive summary: The approach which should be followed

- Taxpayers should have certainty about their overall tax burden and the progress of debt and deficit reduction over future years.
- The attempt to adopt higher progressivity as a way to obtain higher revenues should be abandoned.
- Taxes should be as flat as possible avoiding high marginal rates.
- Uncertainty about repeated policy change is to be avoided.
- We should be assured that a lower proportion of tax will be taken from the economy in future years.
- We should not spend beyond our means.
- We should not expect that infrastructure spending or other Keynesian stimuli do anything to improve the economic performance of Scotland.

Nomenclature:

Throughout this document we refer to the static scores and dynamic scores of tax policy measures.

Static score calculations of potential tax revenues adopt a short time horizon, often the next annual tax round and assume no behavioural change as a consequence of tax changes.

Dynamic score projections consider longer periods and include behavioural change and its subsequent effects on the trend in revenues paid by individuals and the performance of the overall economy.

- **How can the Scottish Government’s four principles to underpin Scottish taxation policy best be achieved?**

There is a lot of evidence to show that, in taxation design, the role of perceptions and expectations about the future is vital. In this, there is a serious problem for policy makers – they cannot know the individual circumstances of taxpayers and therefore their perceptions and expectations.

The attempt to know any “ability to pay” is fraught with difficulty. Policy makers have to imagine the reactions through time of:

- Those without a family
- Those with families
- The thrifty and investing family
- The high consuming non-investing family
- The rich elderly
- The less well-off young
- The poor elderly
- The well-off young
- Other need specific groups

A one size fits all approach with deeply embedded progressivity carries with it a raft of assumptions about the perceptions, expectations and desires of these cohorts. These assumptions are bound to be wrong and taxation thereby affects individual decision making – in essence coercing changes in lifestyles both through design, but also through unintended but unknowable effects.

Tax designers, therefore, are forced to approach the notion of “ability to pay” with great caution. Do we mean the ability to pay for our needs today, our needs tomorrow, for our children’s sake today and tomorrow, or for our retirement tomorrow; with all of these needs relating to the perception of our means today and tomorrow?

Classical liberal economists have therefore been forced to a conclusion that **the design of all taxes should have rates that are flat and high rates should be avoided.**

Consequences emerge if these guiding properties about “ability to pay” are not followed.

As soon as rates are made more progressive or become high, perceptions and expectations change, behaviour changes, and a set of unexpected, changeable and variable outcomes emerge from different cohorts of taxpayers.

This in turn leads policy makers to have to adjust their design to meet inimical effects for some groups. The outcome is that the tax code becomes replete with reliefs and entitlements, the cost of preparing tax returns soars, and the cost of collection rises.

Through time, tax revenues per earned pound fall as rates rise, particularly as those with greater means find ways of using the adjusted code to best advantage. Crucially, such adjustments tend to run counter to policy intentions to enhance equality of incomes; rather, through obtaining tax privileges and using economic power, the well-off enhance their incomes at the expense of others less well-off than them.

The “ability to pay” is thereby inextricably linked with certainty, but not certainty as perceived by policy makers, (un)certainty as perceived by taxpayers’ expectations about their futures - unknowable to tax policy designers.

The “convenience and ease of payment” is then made complex by diverse taxpayer reactions and the tax design becomes less “efficient” through time.

Our conclusion is that proportionality rather than progressivity should be the touchstone of tax design – that is, make all taxes flat with low rates. This approach has the happy outcome of improving economic performance and, paradoxically, can make incomes more equal.

- **How does the current taxation regime and proposals for newly devolved taxes align against these four principles?**

The present regime for income tax already involves the top one percent of UK earners paying more than 25% of all revenues. Recent threshold rises have released many low earners from paying any income tax. However, we have also seen an enormous rise in self-employment among the less well-off where the NIC and income tax burden is proportionately reduced – with employee benefits lost. There appears to be a similar change rapidly emerging in the creative industries among the middle-class young seeking careers in the digital industries.

We see these trends as a result of high progressive marginal rates involving a basic rate of combined NIC and income tax of 32.8%. Jobs, growth and incomes are curtailed by such high taxes.

Generating more revenue under these influences is extremely difficult and likely to be less and less efficient.

Important in our view for Scotland (where we have very few very high earners) is the impact of the higher 40% rate and its threshold. With NIC payments and pension contributions this means that many talented specialists and professionals are paying marginal rates of around 60%.

We should not under-estimate the past effects of this regime and the changes it has made today to the life plans, productivity and employment prospects of our talented staffs. As stated above, presumptions about an ability to pay based on static score revenue assumptions, as these taxpayers react to the certainty of such a high marginal rate, are almost certainly misguided. It is extremely inconvenient to have to pay more than half of your marginal income to the state and, for example, losing a quarter of our trained graduates abroad and fifteen percent of our entire population to the rest of the UK through time is certainly not efficient for Scotland’s productive capabilities through talented people.

We would also remind the committee that many of those skilled staffs on higher rates are working in the public sector where salaries are around 16% higher than in the private sector. A money-go-round of our tax payments has been created as salaries are inflated to retain high quality staff, demanding more tax revenues to fund public sector activity. Where the public sector is large this overall effect is neither proportionate nor efficient.

This lack of proportion has its impact increased by the uncertainty it creates in the private sector as to the future burden of taxation. Any uncertainty in policy is inimical to economic performance¹. Scotland presently has no long term projection about its public finances, although we welcome the new Fiscal Commission's early work to address this.

As for the future, information is sparse, although the perception and expectation about a move towards greater progressivity is well embedded. As explained above, we consider that proposals about higher progressivity in Scottish tax design in the future hold the seeds of their own complexity and distortions within them.

As such, they purport to "align" on the basis of a crude static scoring of what revenues might be obtained from further progressivity, but these estimates are almost certainly wrong.

- **Is there scope for a fundamentally different approach to taxation in Scotland?**

Yes. Scotland should adopt flat taxes, avoid high rates, and reduce the perception that all that is required to enhance economic performance is to spend more money by taking more tax from us. It should act to change the expectation that this is always the stance of the state.

The goal of the Scottish Government should be to increase the rate of growth to 5% and above, enhancing the rate of capital deepening and so put people back to work.

The new Scotland Act offers new, but limited, scope for change. The Scottish Government should use what new powers are available to show the value of marginal tax reductions and then lobby for control of payroll taxes and capital taxes.

It is essential that the overall burden of state activity is reduced. High taxes impoverish us all.²

- **Should (the revenue from) future tax changes be ring-fenced and if so, how? If not, why?**

We have assumed that this question is about the revenue from ring-fencing.

The hypothecation of tax revenues is an admission that they are not generalised collections but rather specific spending commitments.

In that case they should be released from state control to become private payment plans or as separated out mandatory contributions governed by specific legislation. i.e. new taxes created for a transparent purpose. We would favour all such legislation being created as "sunset" legislation; that is time-limited and requiring a clear vote in Parliament for its continuance each year.

¹ That policy stability affects economic growth is an area of major study in economics following our recent extended recession. See: <https://iea.org.uk/publications/research/policy-stability-and-economic-growth-lessons-from-the-great-recession>

² A good European Central Bank review of the effect of higher payroll and capital tax can be found at <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1174.pdf?344d6e77a58718332bd900b10e4d85b2>

Transparency in taxation and spending is a *sine qua non* of good democratic governance. Taxpayers need to know what its government is doing with its impositions on their incomes.

- **To what extent do potential behavioural responses limit options for tax changes in Scotland?**

To the same extent as they do for all countries. There is no doubt that tax competition allows (as competition always does) the discovery of innovative ways of designing public policy. We have seen several instances of this already with the end of the slab method of property taxation when LBTT was introduced, and by the introduction of the buy-to-rent supplement following the rUK.

The real answer to how much behavioural change limit options on tax policy depends on what timescale is considered. We have to conclude that the use of the word “limit” in the question assumes that the consideration is being made of tax increases. If the phrase “drive options” were used it is also possible to consider options for tax decreases.

Short term - up to three years:

In this period behavioural change will involve curtailment of personal and corporate investment, plus planning for change in future economic actions. This tends to lead to unanticipated stagnation. For the policy maker observing changes, the policy outcomes tend not to be seen as adverse; their effects are hidden within a general lack of growth for unknown, and unknowable, reasons.

It is likely that the present low growth in the developed world is due to a generally over-high tax burden based on an ageing population and high social support costs. There is a general consensus among classical liberal economists that Keynesian stimulus measures using state spending to enhance economic performance are a spent force. Where the proportion of an economy controlled by the state is more than around 30% such measures, such as infrastructure spending, have little effect on growth. Rather, they tend to distort capital allocation, increase the debt burden, and require taxes to stay high. The behaviour of individual and business investors changes to divert and curtail entrepreneurial investment – which usually offer much higher returns to capital invested. Capital deepening slows and a trend is set for lower growth rates in the medium and longer term.

Medium term – up to ten years:

In this period, the loss of talent and investment to more fruitful areas of returns takes place. For Scotland this would mean there would be a trend to over-the-border investments rather than local. Inward investment trends would be neutral or negative.

This includes both some flight of liquid and physical capital, but more importantly the departure of talented individuals seeking long-term gain elsewhere. There would also be brass plaque manoeuvres by business.

Work by Magnus Henrekson and Andreas Berg of the Research Institute for Industrial Economics in Sweden ³ shows that medium term economic growth is heavily influenced by the size of the state sector.

Long term – a generation:

The overall effect depends on the nature of technological change and, today, the extent to which digitisation of business processes means that trade can be done from over-the-border sources. Any capital migration will be felt through higher importation of physical goods, with supply chains in Scotland being led less by manufacturing, and more by distribution, businesses.

Should Scotland become perennially less active a lower cost base for manufacture will be retained and will protect some jobs for as long as we have a trade border without undue tariff barriers.

A counter trend to the effects above could be created by reversing policy to reduce the tax burden and overall tax take within the economy.

The extent to which a beneficial trend can be re-instated favouring economic growth is not related to natural resources or the availability of capital, but to the presence of entrepreneurial skills and confidence in the future. The time horizons of these can change economic performance are longer than that of Parliament, but early advances can be made through clear policy choices that include longer term intentions.

These have in turn to be bounded by quality governmental institutions protecting private property rights, unregulated pricing and a general perception and expectation that private gain will allow margins to be ploughed back into further investment and knowledge. In this respect, low payroll and capital taxes are vitally important. ⁴

- **To what extent do the mechanisms for administering the Scottish income tax system via HMRC limit the scope for a different tax system in Scotland to develop?**

We are not party to particular administrative arrangements, but we would suggest that there is no reason why Scotland should not be permitted to have its own exchequer and tax collection authority.

The important thing is to allow innovation. Should HMRC be imbued with present tax designs for rUK and Scotland decide to change to a simpler system – that is with lower and flatter rates and less reliefs – the disjunction between the way the two systems operate will lessen the commonality of practice. It would only make sense then to bring the administration of Scottish tax collections to Scotland.

³ Good summary at <http://www.wsj.com/articles/SB10001424052748704535004575348641192320912> or the full work at http://www.ifn.se/eng/about_ifn/news/headlines-2010/government_size_and_implications_for_economic_growth

⁴ Again, see the ECB evidence.

- **Are there any other administrative limitations to the emergence of a Scottish tax system?**

We believe that there is an opportunity for Scotland that emerges from the size of its tax base. To create a simpler, flatter system with fewer reliefs based on the payments of around two and a half million individual and corporate taxpayers is a great deal less onerous than doing the same for the, approximately, 25 million individuals in rUK.

There is a real opportunity for Scotland, if allowed more autonomy in collection and if it adopts fewer taxes with a concentration on consumption taxes, rather than complex payroll and corporate taxes, to reduce its collections costs dramatically.

A thriving and growing Scotland would have to become highly fleet-of-foot in its ability to deal with international taxation matters, especially if we raised the rate of investment by overseas entities by an order of magnitude (something which we would see as a policy goal). We do not see that international agreements over taxation would give Scotland major administrative issues; although the trend for governments to seek pan-national tax regimes based on peculiar understandings of the purpose of tax havens, and a lack of recognition of the distorting corporate profit and capital taxation regimes, is deeply concerning.

If Scotland makes a serious effort at a simplified tax regime with concomitant clarity in forward spending plans, Revenue Scotland could cope well with a large increase in economic activity.

Summary

The general thrust of our submission is to reinforce recognition of what is called the supply-side. We also want to stress that a mechanical “static score” approach to policy avoids the real economic issues of perceptions and expectations.

It is the unknowable reactions of individuals and businesses to their own perceptions about the future that will make a success of tax policy in the medium and longer term.

We live in a highly taxed economy today. Payroll taxes taken as a whole are particularly high and these rates in our view delineate to a great extent the attitude to work productivity in our society.

Scotland does not produce enough, fast enough, in as many sectors as it could. We need a much better focus on how we can harness the skills of our people to generate far faster capital deepening – the development of human knowledge and skills that earn revenue and the creation of physical capital assets that also generate revenue.

It is those revenues that we need to enhance – they will produce the tax revenues needed for public purposes in good time, and those revenues will be far higher than those obtainable through higher more progressive rates.