Economic perspectives

The tartan tax versus other revenue-raising options

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Introduction

Much has already been written about the devolved Scottish Parliament's Tartan Tax-varying powers (for example Blow et al. 1996, Darby et al. 2002, Heald and Geaughan 1996 and 1999, Heald et al. 1998, Heald and McLeod 2002, McGregor et al. 1997, Midwinter 2002, Muscatelli 2001, SPICe 2002). Much less has been written about other revenue raising options and it is the contention of this paper that the focus of attention on Tartan Tax-varying powers has been misplaced.

The Tartan Tax literature notes that tax-varying powers are only partial and heavily restricted, being more symbolic than real, and making little or no difference in terms of total financial resources available to the Scottish Executive than what would have been the case in the absence of devolution. In other words, except for relatively high council tax bills (not a decision of the Scottish Parliament per se), the structure, rates and/or levels of taxation in Scotland are those of the UK.

It is perhaps not surprising that the Scottish Parliament's Tartan Tax-varying powers remain unused. The UK Labour Government plans real term increases in the Scottish Block grant of 4.4 per cent per annum up to 2005/06 (Treasury 2002a). Moreover, public expenditure is already relatively high in both per capita terms and as a percentage of GDP (Nelson 2003). In fact, rather than adding to the UK tax rate on basic incomes there seems to be more scope for reducing the UK basic rate. This is evidenced by various decisions of the Scottish Parliament leading to lost revenues and/or increased expenditures (Mitchell et al. 2001). First, the more generous recent pay award to teachers in Scottish schools than in English schools. Second, the abolition of up-front university tuition fees, leading to the increased take-up of university places. Third, the abolition of charges for personal care of the elderly, leading to increased take-up of residential and community-care services. Fourth, making provision for free off-peak local bus travel for all elderly and disabled concessionary cardholders, and as extended to peak hours by some local authorities.

These decisions may not have been properly costed, for example as subsequently claimed by Scottish local authori-

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ties in respect of free personal care. Nevertheless, they do indicate the possibility of using the Tartan Tax-varying powers to reduce income tax in Scotland, had those decisions to scrap charges and/or increase expenditures not been made.

Specifically Scottish spending decisions are not funded via the Barnett Formula, which gives Scotland a predetermined proportion of incremental public expenditures in England. Hence, the financial implications of abolition of charges in Scotland but not in England will not be allowed for in the Scottish Block grant paid by the Westminster government to the Holyrood government. Thus, unless those decisions have been properly costed, the Block may provide insufficient money to finance these decisions. In addition, the UK-level of government may be unwilling to fully fund (via 'Barnett bypass') pay awards that are more generous in Scotland than in England. If it does actually exist, the so-called Barnett Squeeze would add to the financial pressures impinging upon the Scottish Budget. Nevertheless, these and other pressures will not require the Tartan Tax to be levied as long as cost savings can be made for other devolved services and/or other sources of finance can be increased (see below).

Potential Tartan Tax revenues

Any change in the rate of Tartan Tax is limited to a maximum of plus or minus 3p in the pound and only applies to the basic rate of personal income tax, not to the higher or lower rates. Moreover, the Tartan Tax cannot be levied on income from savings and distributions (i.e. interest payments and dividends from shares): it is levied on earned income from employment. Earned income was only 57 per cent of personal income for PAYE income tax purposes in 1999 (Scottish Executive 2002a). Clearly, the Tartan Tax base is relatively narrow when compared with total personal income.

Besides being affected by the net change in tax allowances, the tax revenue is also clearly affected by changes in total employment incomes within the basic rate tax bracket. Originally, the UK Treasury estimated that each additional penny of Tartan Tax would raise £150 million per annum. This estimate was derived from the restricted Scottish basic rate personal income tax base in 1997/98. However, the base of the basic rate band of UK personal income tax was broadened in the 1999 budget. This led to an increased estimated revenue yield from one penny of Tartan Tax to £230 million per annum. Although this would enable more revenue to be raised for a given tax rate, this sharp change perhaps demonstrated just how volatile the Tartan Tax base can be in reflecting UK central government decisions. However, the Scotland Act 1998 s76 makes provision for the UK Treasury to offset such volatility relative to the amounts that would have been raised in 1997/98 after making due allowances for changes in the retail prices index.

It seems reasonable to compare inflation of employment earnings and of retail prices with Treasury estimates of the yield of the Tartan Tax to analyse changes over time in the real yield of the Tax. Had there been no changes to the basic rate tax base, and had that base increased in line with the increase in average Scottish employment earnings, the resulting revenues would have been those presented in Table 1. Of course, the earnings index includes those in the lower, basic and higher rate tax brackets. Hence, use of the average growth of all earnings (rather than only of earnings within the basic rate tax band) is an approximation of broad magnitudes rather than a precise calculation.

However, any distortion is perhaps unlikely to be significant. The arithmetic average growth of employment earnings is generally inflated by more rapid growth of the highest incomes, these not being within the Tartan Tax band. Nevertheless, the arithmetic average is also reduced by relatively slow growth of the lowest incomes, these also generally not being within the base of the Tartan Tax. This is because the combined effect of the personal allowance, the starting rate tax band and the working families tax credit and children's tax credit (and their successor credits) means that the lowest earned incomes do not pay basic rate tax. These two effects will tend to be offsetting such that use of average earnings seems justified.

Table 1 also shows what revenues would have been if they had kept up with inflation as measured by the index of retail prices (RPI). Both sets of figures can be compared with the Treasury estimates. The potential Tartan Tax receipts rose between 1999 and 2000 faster than the RPI but then fell by 2.1% and then by 1.0 per cent in real terms in 2001 and 2002 respectively. This is because the UK Treasury's estimates of potential Tartan Tax revenues remained constant in those two years whilst the RPI rose. The real value of the potential Tartan Tax yield fell faster against the Scottish employment earnings index because the rise in earnings was substantially greater than the rise in the RPI.

Comparing the cumulative totals in Table 1, it is clear that potential Tartan Tax revenues did not keep up with either retail price inflation or growth of average employment earnings during the first four year term of the Scottish Parliament. Changes in the costs of providing public services approximate changes in average earnings more closely than changes in retail prices because wages and salaries account for a high proportion of service costs. Thus, there was a fairly substantial decline in the real value of potential Tartan Tax revenues during the first term of the Scottish Parliament.

Table 2 calculates annual tax receipts resulting from a 1p Tartan Tax rate over the following four years assuming they keep up with an RPI of 2.5 per cent in each year and, alternatively, with annual growth of Scottish employment earnings of 5 per cent. Whilst these rates are arbitrary, they broadly reflect the situation in 2000/01 (see Table 1) and also the fact that Scottish average employment earnings generally rise twice as fast as retail prices. For example, between 1991 and 2001 the UK RPI rose by 31 per cent whereas average employment earnings in Scotland rose by 61 per cent. More recently, between 1997 and 2002 retail prices rose 13.0 per cent whilst Scottish earnings increased by 26.8 per cent. The differential in growth rates of earnings and prices assumed in Table 2 is therefore typical of past trends. Nevertheless, the resulting financial figures are simplistic and purely illustrative, not being meant to be forecasts. They assume no further changes to the basic rate tax base (e.g. no net change in allowances) and 'constant employment'.

If the Scottish Executive had levied a Tartan Tax during the first four years of the Scottish Parliament it could have raised £930 million from a 1p tax rate, according to Treasury estimates (Table 1). In its second four-year term of office it would raise either £978.95 million or £1040.90 million (on the assumed growth rates) from a 1p tax rate. These figures are doubled by a 2p tax rate and tripled by a 3p tax rate, assuming that the extra tax receipts have no adverse effects on the Scottish economy in terms of disincentives to work or to invest.

As already noted, the Tartan Tax base should be index linked to the growth of total taxable incomes (rather than average earnings) within the basic rate tax bracket and also adjusted by the net changes since 1999 in total allowances against (basic rate) personal income tax. They should also be adjusted by changes in the tax thresholds determining the width of the basic rate tax band. Some tax allowances have been withdrawn, others introduced and increased. Calculation of the net change for Scotland is therefore

Table 1: Products of 1p Tartan Tax rate

Year	*Growth of UK RPI (%)*	*Tax Product (£m) if linked to RPI*	*Growth in Scottish Employment Earnings Index (%)*	*Tax Product (£m) if linked to earnings*	*Treasury Estimate (£m)*
1999		230.00		230.00	230.00
2000	3.0	236.90	5.0	241.50	240.00
2001	2.1	241.87	5.6	255.02	230.00
2002	1.0	244.29	5.6	269.30	230.00
Cumulative Total		953.06		995.82	930.00

Sources: HM Treasury, Office of National Statistics and authors' calculations.

Table 2: Illustrative calculations of future products of 1p Tartan Tax rate (£ million)

	2002 Treasury Tax Product of £230 million Indexed to:		
Year	*RPI of +2.5% p.a. Column A*	*Earnings Growth of 5% p.a. (Column B)*	*Column B minus Column A*
2003	235.75	241.50	5.75
2004	241.64	253.58	11.94
2005	247.68	266.25	18.57
2006	253.88	279.57	25.69
Cumulative Totals 2002-2006	978.95	1040.90	61.95

Source: authors' calculations

problematic and no attempt can be made to adjust for unknown future changes. This emphasises that the figures in Table 2 are purely illustrative of broad magnitudes: they are not predictions.

Besides being constrained by the maximum change in tax rate and the doubly restricted tax base, exercise of the tax-varying powers may be further restricted by the UK government changing other taxes. Any substantial changes in the UK-level structure of personal income tax and/or national insurance contributions (NICs) will, almost inevitably, take precedence over use of the tax-varying powers by the Scottish Parliament. A possible scenario is where the combined effect of UK-level changes to the rate or structure of income tax and/or NICs and Scottish-level changes to the rate of the Tartan Tax results in a significantly lower level of take-home pay in Scotland.

The UK Labour Government announced four increases in NICs as from April 2003. First, a one per cent increase in both employees' and employers' NICs. Second, the application of that increase not just above the employees' lower earnings limit, but also above the upper earnings limit. Third, the freezing of the lower earnings limit above which NICs are paid (i.e. no upward adjustment for inflation). Fourth, the increase in the upper earnings limit in line with retail prices rather than earnings (the former rising more slowly than the latter, as already noted). The combined effect of these increases in employees' NICs is estimated to reduce take-home pay by more than £5 a week for those on middle incomes. This is broadly the same group as those who would have to pay the Tartan Tax levied on earnings subject to the basic rate of UK tax. Thus, the Scottish Parliament may feel unable to levy the Tartan Tax in the foreseeable future.

Employees' NICs may be regarded as personal income tax by another name, especially as the structures of both forms of taxation are being progressively reformed so that they increasingly correspond with each other. Even if taxpayers do regard NICs as separate from income tax, the fact is that the increased payments of NICs leave taxpayers with less disposable income. This is exacerbated by the fact that the tax base for NICs is not total income but, instead, earnings from employment. Like the Tartan Tax, NICs are not paid on unearned income from savings and dividends.

Levying the Tartan Tax would therefore cause an even greater differential between the taxation of earned versus unearned incomes, with possible adverse effects on economic growth within Scotland. Adding the Tartan Tax at a rate of 3p in the £ to employees' NICs of 11p in the pound (between the lower and upper earnings limits) means that these middle earnings would be taxed at an even higher rate than unearned incomes in Scotland. Thus, the Scottish Executive may feel unable to reduce disposable income further by adding to the tax take on earnings.

The restriction would be made more severe if account is taken of all central government taxes paid by Scottish taxpayers. Thus changes in the structure and/or rates of VAT, and of other taxes on expenditure, could further restrict changes in the rate of Tartan Tax. Besides UK central government taxes, sharp changes in the rate of council tax in Scotland could also impinge upon the ability of the Scottish Parliament to vary simultaneously the rate of Tartan Tax.

The constraints on tax rate increases may be paralleled by political restraints on tax rate reductions. Given the relatively high level of public expenditure in Scotland (noted above) a tax rate reduction may be seen as confirmation of claims that Scotland is over-subsidised. Thus, there is considerable uncertainty about just how far the Scottish Parliament can actually exercise its tax-varying powers in practice.

This makes clear the somewhat misleading claim in the 1997 White Paper 'Scotland's Parliament' (Cm 3658) that a regional income tax is broadly based, simple and easy to understand and viable. It is clear that the Tartan Tax is not as broad based as it could be, doubtful whether the Scottish electorate fully appreciates how that base is determined and doubtful whether it is worth using in practice.

As noted above, a Tartan Tax rate of 1p would have raised £230 million in 2002. Planned devolved spending in that year was £17,775 million. Thus, a Tartan Tax rate of 1p in the £ would add only 1.3 per cent to devolved expenditure. Hence, the maximum amount by which devolved expenditure could be increased would be only 3.9 per cent. The illustrative figures in Table 2 are likewise relatively modest. In practice, these low proportionate figures are further reduced because collection costs will be deducted from any revenues raised by the Tartan Tax. By way of comparison, Scottish local authorities finance 15 per cent of their general fund revenue expenditure from council tax.

Political parties' policy proposals

The Scottish Labour Party promised not to use the Tartan Tax during its first four-year term of office, this policy subsequently being adopted by the Labour/Liberal Democratic coalition which formed the Scottish Executive in 1999. There is no indication thus far that this will change in its second term of office following the May 2003 election. Indeed, none of the main political parties' manifestos for those elections proposed levying the Tartan Tax.

The Liberal Democrats proposed a local income tax (LIT) and to allow each local authority to retain the business rates income generated in its area, making local authorities responsible for raising the majority of their own income. However, they would also transfer Health Board functions and water and sewerage to local government. The introduction of the LIT and the transfer of service responsibilities to local government would reduce the need for a Liberal Democrat-controlled Scottish Parliament to levy the Tartan Tax.

In contrast to the Liberal Democrats' transfer of service responsibilities to local government, the Conservatives proposed to remove from local authorities responsibility for education and health-related social services in order to reduce the burden on council tax. The Conservatives pledged to cut taxes on people and businesses whilst maintaining the levels and standards of public services. This they planned to achieve by reducing inefficiency in service provision, by reducing wasteful use of public finance, and by using the extra tax revenues generated by economic growth. Whilst proposing to restore a uniform business rate poundage across the UK, the Scottish Conservatives also pledged to cut business rates for rural shops, pubs & village post offices (many already qualifying for 50% mandatory relief). In fact, the Local Government in Scotland Act 2003 subsequently extended mandatory reliefs for qualifying food stores and certain agricultural and heritage subjects. Promising tax cuts, it seems unlikely that a Conservative controlled Scottish Parliament would levy the Tartan Tax.

The Scottish National Party (SNP) wants full financial and political independence for the Scottish Parliament. Full independence would require all taxes to be set and collected by Scottish government. Hence, the Scotland Act 1998 and the associated tax-varying powers would be redundant. Nevertheless, in practice, if not in principle, an independent Scotland's tax-varying powers may still be constrained because there may be an element of tax competition between England and Scotland, each country restraining (if not cutting) the levels of taxes it imposes on geographically mobile business and labour.

If elected to power, the Scottish Socialist Party (SSP) promised to abolish council tax, replacing it with a Scottish Service Tax (SST). Based on a proposal by academics at the University of Paisley (Danson and Whittam 2002), it is said to be a local income tax. This would only be the case if local authorities were free to set their own rates of tax. In fact, the Paisley academics propose that the rate be set by the Scottish Parliament, the revenues from which would be dedicated to local government.

Although workable and able to raise potentially very large amounts of tax receipts, doubts have been expressed about whether such a tax falls within the remit of the Scotland Act 1998. As already noted, the tax-varying powers specified in the Act relate to the basic rate of UK income tax and are limited to plus or minus 3p in the £ of employment earnings. The highly progressive SST would alter the higher rate as well as the basic rate. This would be contrary to the Act. This is why the SSP and Paisley academics refer (rather disingenuously) to the SST as a local income tax. In fact it is a regional tax, the revenues of which are assigned to local government, in the same way as business rates. Thus whilst workable, the SST may not be within the legal competence of the Scottish Parliament. If it were within the Parliament's legal competence, it would limit the ability of the Scottish Parliament to raise the Tartan Tax to improve the NHS and other services not financed by the SST.

The only party planning to use the tax-varying powers was the newly formed Scottish People's Alliance, a radical right-of-centre party committed to minimalist government. However, rather than increase the tax rate, the Alliance promised an immediate cut of 3p in the pound. This could lead to the political problems noted above in terms of reinforcing perceptions of an over-subsidised and now under-taxed Scotland.

The lack of commitment of any mainstream political party to levy the Tartan Tax during the second term of the Scottish Parliament gives more substance to warnings that this devolved power would prove to be a watchdog that would not bark (Jackson 1999) and would soon atrophy (Heald and Geaughan 1997).

Other revenue raising powers

Besides the Tartan Tax, the Scottish Parliament also has the power to vary the rate of the property tax paid by Scottish businesses and other non-domestic rateable properties. In practice, however, that tax-varying power has been heavily constrained by the perceived need to harmonise Scottish business property tax bills with those paid by businesses in England. In its response (Scottish Executive 1999) to the report of the Commission on Local Government and the Scottish Parliament (McIntosh 1999), the Scottish Executive committed itself to maintaining the principles of cross-border harmonisation and a level playing field for business and industry, Scotland vis-à-vis England. Allowing for transitional arrangements following revaluation (Heald and McLeod 2002), this means that differences in business rate poundages between Scotland and England will be offset by opposite differences in average valuations such that average tax bills (as distinct from tax rates) are harmonised. Nevertheless, the Conservatives pledged to harmonise (i.e. cut) tax rates.

Thus business rates will not be used actively to raise additional tax revenues for Scotland and so the tax revenues raised will effectively be determined by the UK central government's decisions in respect of business rates in England. Business rates would be made variable under some political parties' proposals but at the local (rather than regional) level.

The most feasible tax option would be to broaden the base of council tax to raise more revenue for a given tax rate (Scottish Executive 2002b). Subject to approval by the Scottish Parliament, the Local Government in Scotland Act

2003 allows Ministers to set council tax charges for second homes and long-term empty homes, these currently being half-rated. Although not allowed for by the Act, the council tax base could also be broadened by reducing the 25% deduction for single person households. Adding more valuation bands at the top and bottom of the council tax range (so that they are, respectively, larger and smaller multiples of Band D) would not in itself raise more tax revenue. Nevertheless, broadening the tax base in this way could make higher rates of council tax more politically acceptable. However, the UK government could reduce the Scottish Block if local authority self-financed expenditure (i.e. funded by council tax) in Scotland grew significantly faster than in England and/or was inconsistent with macroeconomic policy (Treasury 2002b).

Likewise exemptions from business rates could be cancelled in order to broaden the tax base. Currently, sporting estates, agricultural land and churches are exempt from business rates. Many charitable organisations also have their rates liability abated in full (80% mandatory, 20% discretionary). Such exemptions are questionable, especially where they reflect past practice rather than current conditions. Moreover, those tax exemptions may be offset by higher rents and leases, with the result that the main beneficiary is the landowner or property owner - not the tenant. In fact, as already noted, the Local Government in Scotland Act 2003 extended reliefs against business rates for certain agricultural properties and heritages.

Nationalisation of business rates and the consequent severing of links between councils and businesses in their jurisdictions has led to proposals for the establishment of business improvement districts (BIDs) in the UK. The Local Government Act 2003 confirmed the UK Labour Government's White Paper (Cm 5237) proposal to introduce BIDs in England. They will work in partnership with local authorities in areas with identifiable business communities (ODPM 2002). Enabling legislation is expected to be operational in 2004. They will have to be approved by a majority of businesses in the BID, payment of the resulting additional business property tax then being compulsory. They will not be levied on domestic properties in the BID areas, even though they are expected to benefit. BIDs could make a valuable additional financial contribution for improvement of specific business areas within cities. They could be used to finance crime prevention (e.g. CCTV cameras), remedial measures (e.g. dealing with vandalism), more frequent bus services to shopping centres (especially if 'out of town'), local training and employment schemes etc. Either enabling legislation would have to be passed or individual authorities would have to promote BIDs bills through the Scottish Parliament.

Non-tax income sources include service charges, grants raised through competitive bidding systems (e.g. regeneration funds and the 'good causes' grants financed by the National Lottery), donations and bequests, and payments-in-kind such as planning gain/obligations. It is not, however, possible to gain additional revenues from privatisation receipts, trading surpluses or from increases in council rents greater than those allowed for by the UK government. The UK government has made clear that it would make offsetting adjustments to the Scottish block grant, in the rents case because of the greater than expected payments of Housing Benefit that the UK government would have to make (Treasury 2002b).

The scope for charging for public services in Scotland is greater than may generally be thought. "The general principle that applies is if a devolved administration chooses to charge more, the additional negative public expenditure receipts will accrue to its budget and if it chooses to charge less it will need to meet the costs from within its budget" (Treasury 2002b p. 21).

Charges are already levied to varying extents for many municipal services. These include charges for school meals, library information services, day nurseries, car parking, burials and crematoria, admission to special exhibitions in museums and galleries and so on. However, both relative and absolute amounts raised are small. Excluding rents, charges generally raise only about a third of the amount raised by council tax and Scottish local authorities raised an average of only £1.25 per head per week in the late 1990s, of which just over a quarter came from planning and economic development (Accounts Commission 1998).

Thus, there is probably considerable scope to increase existing levels of charges, particularly if low-income groups benefited from means tested (and therefore reduced) charges and service vouchers. As regards introduction of new charges, ring-fenced city road (congestion) charges are currently being considered. Though they could raise relatively large sums of money for public transport in Scottish cities, the experience of the London congestion charge is that less money has been raised than was first expected.

Outside local government, whilst it was noted above that up-front university tuition fees have been scrapped, there is still considerable potential for more use to be made of charges, for example charging patients who miss appointments with their general practitioners or hospitals. Nevertheless, there is currently considerable political pressure building to reduce water charges levied on Scottish businesses (these being relatively high when compared with those in England).

Conclusions

It seems highly unlikely that the Tartan Tax will be levied in the foreseeable future. This is ironic given the Yes: Yes outcome of the referendum for the Scottish Parliament (Scotland Forward 1998). Nevertheless, the Tartan Tax would raise relatively little extra tax revenue net of collection costs and is perhaps not yet justifiable given the present UK Labour Government's plans to increase public expenditure in real terms and Scotland's already relatively high level of public spending.

The only substantially untapped and sustainable source of truly additional revenues that would not be affected by offsetting changes through the Scottish Block is charging for public services. The UK Government's view is that revenue from fees and charges (excluding council rents) should not be subject to any form of resource equalisation. In fact, the Scottish Parliament seems more prone to abolish service charges than to increase them and/or extend their coverage. Whether in an upward or downward direction, the Scottish Parliament is obviously much more willing to vary non-tax revenues than to vary tax revenues. In this respect, the focus of attention on tax-varying powers is misplaced. Powers at both regional and local levels to vary income from service charges should be recognised more fully. Existing powers to charge service users are arguably grossly under-developed. Ultimately, the greatest potential for varying revenues relates to non-tax revenues, not to tax revenues. Whilst the power to vary taxes may indeed be more symbolic than real, powers to vary charges are both real and substantial.

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