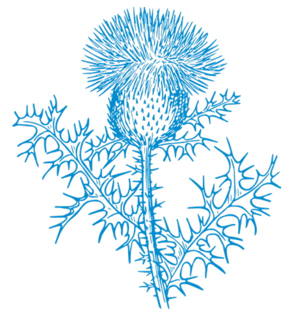

Scottish Policy Foundation

Scotland's tax powers

April 2018

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Scotland's tax powers

Tax revenues which are devolved to the Scottish Parliament – and over which the Scottish Parliament has substantial control – now account for almost half of the Scottish Government's day-to-day budget. Decisions on tax influence not only the resources available to fund government spending, but can also be used to influence the behaviour of individuals and businesses in Scotland. This note summarises some of the recent changes to Scotland's devolved taxes, and highlights some areas for policy research. The Scottish Policy Foundation's model of the Scottish economy can be used to examine the wide economic effects of the changes in the devolved fiscal policy. Here we illustrate the use of the model with the simple increase of the income tax.

Introduction

Until 2014, only two taxes were controlled within Scotland: Council Tax and Non-Domestic Rates (often known as Business Rates). The vast majority of the Scottish Budget was determined by a block grant from Westminster – which in turn, was operated by the Barnett Formula.

Following the Calman Commission, Stamp Duty on property transactions and landfill tax were transferred to Holyrood in 2015 alongside a partial transfer of income tax the following year. A new tax to replace Stamp Duty was created, the Land and Buildings Transactions Tax (LBTT).

The partial devolution of income tax was only operational for one year – 2016/17. This was because the 2014 Smith Commission recommended that income tax revenues levied on 'non-savings, non-dividend' income should be transferred in full to the Scottish Parliament, with MSPs having the ability to vary rates and bands without constraint, and this full transfer of income tax revenues took place in 2017/18.

The Smith Commission also recommended that Air Passenger Duty and the Aggregates Levy be devolved to the Scottish Parliament. Finally, it recommended that approximately half of VAT revenues raised should be assigned to the Scottish budget.

Table 1 summarises the revenues that currently, or will imminently, form part of the Scottish budget.

Table 1: Scottish budget forecast revenues, 2018/19

Tax	Date of transfer/ devolution	Forecast revenues raised 2018/19 (£m)	Degree of control by Scottish Parliament
Land and Business Transactions Tax (LBTT)	2015	£588	Fully devolved; complete autonomy.
Landfill Tax	2015	£106	Fully devolved; complete autonomy.
Income tax	2017	£12,177	The Scottish Government can set the rates and bands. But the UK Government defines the tax base and sets allowances.
Air Passenger Duty	tbc	£306	Fully devolved; complete autonomy.
VAT	2019	£5,500	Assigned revenues; no autonomy.
Aggregates Levy	tbc	£55	Fully devolved; complete autonomy.

Source: *Government Expenditure and Revenue Scotland*

But what are the policy options that these new policy levers provide?

* All data correct as of April 2018. Data and analysis compiled by the Fraser of Allander Institute.

This paper considers issues specific to each tax.

Remember throughout that taxation can serve a number of different purposes. Whilst its primary purpose is to raise revenue to fund government expenditure, it is also used to support the redistribution of income (and wealth) within an economy. Taxation can also influence the behaviours of taxpayers, whether these are households, businesses, consumers, etc. Governments can exploit these behavioural responses to support policy objectives, but taxation can also distort behaviours in less desirable ways (and have undesirable consquences).

The Scottish Government aims to base its tax policy around four key principles of taxation which can be traced back to the renowned 18th century Scottish economist Adam Smith. These principles are that taxation should:

- be proportionate to the ability to pay (equality),
- provide certainty to the taxpayer,
- provide convenience and ease of payment,
- and be efficient (in terms of collection costs).

Income tax

The Scottish Parliament can vary income tax rates and bands on non-savings, non-dividend (NSND) income without constraint. NSND income includes income from employment, self-employment, property, and pensions; NSND income tax revenues account for over 90% of all income tax revenue raised in Scotland.

However, the definition of the income tax base is reserved to Westminster. This means that Westminster sets the Personal Allowance, and determines rules on which forms of income are liable to tax. (For example, rules on the proportion of pension income that can be taken free of tax are set at Westminster, not Holyrood).

Strictly speaking therefore, income tax in Scotland is shared between the Scottish and UK Parliaments. The revenues continue to be collected by HMRC before being redistributed to the Scottish budget.

In 2017/18, the first year in which the income tax powers had been transferred to Holyrood, the Scottish Government froze the Higher Rate threshold at its 2016/17 value of £43,000. In contrast, the UK Government increased this threshold to £45,000. As a result, higher rate taxpayers in Scotland paid around £400 per year more in tax than those in the rest of the UK (rUK). The policy is likely to raise an additional £140m of revenue for the Scottish Government, compared to what it would have raised if it had set the threshold at the same level as in rUK.

In 2018/19, the Scottish Government has established a number of new tax bands. A ‘starter rate’ of 19p will apply to the first £2,000 of taxable income. And an ‘intermediate rate’ of 21p will apply to incomes above £24,000. The Higher Rate will be increased by 1p to 41p, and the Additional Rate (which is renamed the ‘top rate’) will be increased by 1p to 46p. Furthermore, whilst the Higher Rate threshold will increase by 1%, to £43,430, this is a proportionately smaller increase than is being observed in the UK (where the threshold will reach £46,350). The changes in 2018/19 are expected to raise around £220m.

Table 2: Scottish income tax bands and rates, and number of taxpayers by band, 2018/19

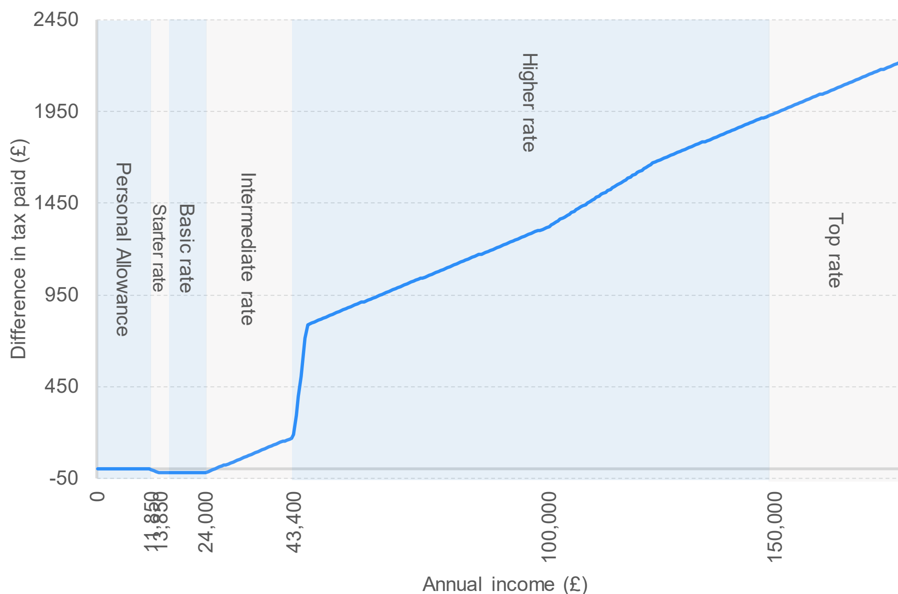
	Income	Marginal rate	No. of taxpayers
Personal Allowance	Up to £11,850	0%	
Starter rate	£11,851 - £13,850	19%	250,400
Basic rate	£13,851 - £24,000	20%	1,031,300
Intermediate rate	£24,001 - £43,430	21%	874,700
Higher rate	£43,431 - £150,000	41%	349,900
Top rate	›£150,000	46%	18,900
Total taxpayers			2,525,200
Non taxpaying adults			1,890,880

Source: *Scottish Fiscal Commission*

Taken together, the 2017/18 and 2018/19 changes combined mean that the Scottish and rUK income tax schedules now look quite different. Tax liabilities are slightly lower (by a maximum of £20) in Scotland than rUK for those with income less than £26,000, as a result of the new starter rate of tax in Scotland. The median income of Scottish income taxpayers is £24,000, so half of Scottish taxpayers pay less tax than they would in rUK.

But tax liabilities are higher in Scotland for those with incomes above £26,000 (at an income of £26,000, the £20 that Scottish taxpayers gained from being taxed at 1p below the rUK rate on £2000 has been offset by being taxed at 1p more than the rUK rate on £2,000 above £24,000). At incomes above £24,000, Scottish taxpayers face a 1% higher marginal rate than rUK taxpayers, apart from the band of income between £43,430 and £46,350 when Scottish taxpayers pay a 21% higher tax rate than rUK taxpayers, as a result of the difference in the Higher Rate threshold (Chart 1).

Chart 1: Difference in income tax liabilities by income, Scotland compared to rUK, 2018/19



Source: *Fraser of Allander Institute*

As a result of the last two years of tax policy decisions in combination, Scottish revenues in 2018/19 are forecast to be around £300m higher than they would have been had Scotland implemented the same policy as rUK.

The big debate around income tax changes is of course how higher rates may induce behavioural change among taxpayers, particularly where tax changes are implemented in Scotland but not in rUK.

There is some concern that higher tax rates might reduce economic activity, either by encouraging people to work less, invest less, or take fewer entrepreneurial risks. In reality there is little empirical evidence that relatively small tax changes induce such effects. Indeed, significant changes to income tax rates within the UK since the 1970s have not been associated with faster growth. And looking across countries, those with lower tax rates have not experienced faster growth in recent decades. At very least this suggests that lots of things matter for growth, of which the tax rate is just one. But perceptions do matter, and there is at least some risk that permanently higher tax rates might dampen economic growth slightly in the long run, particularly if the additional revenues are used in ways that are perceived to be ineffective or inefficient.

There is also concern that higher tax rates may not generate as much revenue as they might, as people change their tax affairs to avoid tax. In response to higher tax rates, some self-employed individuals might be more likely to incorporate (in order to pay themselves in dividends which are charged at the lower UK rate); others may try to change their residence status so as to count as an rUK rather than a Scottish taxpayer; and others may simply be more likely to avoid paying tax in other ways.

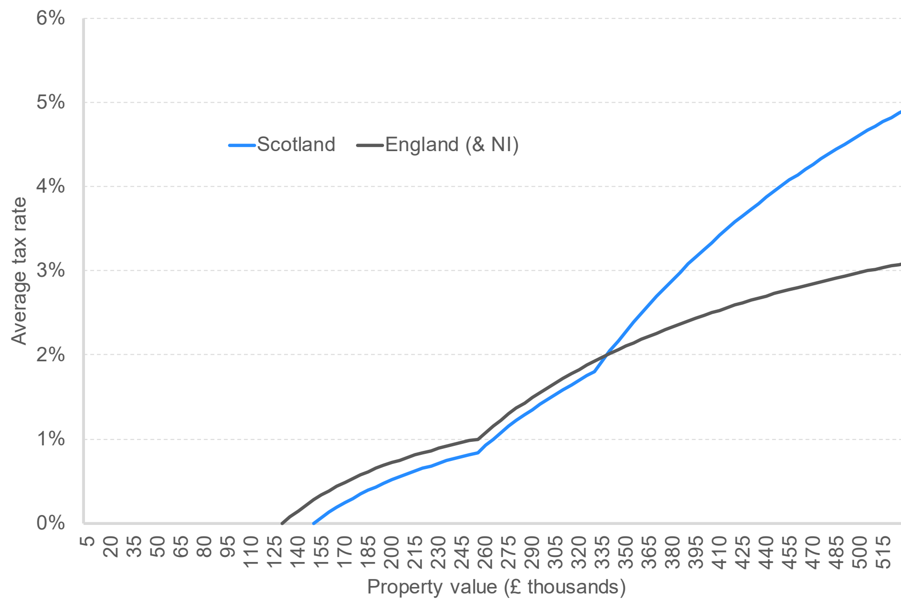
These types of behavioural response are a legitimate concern. The revenue estimate from the 2018/19 policy changes factors in assumptions about how taxpayers are likely to respond, but there is considerable uncertainty about these effects, and the Scottish Government will want to monitor and measure these responses over time.

LBTT

In 2015, the first year that Stamp Duty Land Tax was transferred to Scotland, the Scottish Government introduced in its place a new tax, the Land and Buildings Transactions Tax. In designing LBTT, the Scottish Government heeded critics of Stamp Duty's 'slab' structure (whereby, when a house moves into a higher tax threshold, the higher tax rate is charged on the full value of the property, leading to large jumps in tax liability at particular price points), and designed LBTT so that each additional tax rate is applied only to the portion of property value above that threshold.

This catalysed the UK Government to revise Stamp Duty in the UK, adopting a similar structure as LBTT. However, the rates and bands applied to domestic property in Scotland continue to differ from those in rUK, with properties valued at over £333,000 (around 8% of Scottish properties) facing a higher average tax rate in Scotland. Chart 2 compares residential transactions tax liabilities in Scotland with those in England.

Chart 2: Average tax rate by property value, Scotland compared to England (and NI)



Source: *Fraser of Allander Institute*

Some concerns however have been raised that the structure of residential LBTT – which, as noted above, implies a higher average tax rate on properties over £333,000 than the UK system – has reduced activity in the mid to higher end of the market. In reality there is not yet firm evidence to support this claim. Note however that some slowing of transactions activity is what economic theory might expect to happen. A tax on transactions drives a wedge between the price that buyers are willing to pay and the price at which sellers are prepared to sell. Indeed, a number of studies do find evidence that transactions taxes reduce the number of transactions that take place in the market. To the extent that transactions are mutually beneficial, transactions taxes therefore have undesirable distortionary effects. Indeed the rationale for a tax on transactions is questionable. A case could be made for taxing housing wealth or property value, but the type of tax required to achieve this would look quite different.

Two changes to LBTT have been made in recent years.

In 2016/17 an Additional Dwelling Supplement was introduced in Scotland, mirroring the introduction of a similar tax in England. This is an additional tax rate of 3% of property value if that property is being purchased as a second home. The rationale for the policy is to disincentivise second-home ownership, and as a result to potentially increase the affordability for first-time buyers. The success of the policy will depend on a variety of factors, including the extent to which second homebuyers and first-time buyers compete for similar properties. The ADS is forecast to raise £93m in 2018/19.

In 2018/19, the Scottish Government Scottish Government announced a relief for First Time Buyers (FTBs), expected to apply from 1 June 2018. This raises the zero-tax threshold for FTBs from £145,000 to £175,000 (those who are not FTBs would pay 2 per cent tax in this range). The maximum reduction in tax liability for FTBs as a result of this change is £600. The effects of this policy on increasing FTB transactions is expected to be limited, raising the annual number of FTB transactions by 150-200. This is largely because the effect of the tax reduction will be to raise the prices paid by FTBs (who will effectively use the money saved through the tax reduction to bid up prices)[1]. Thus the policy may mainly benefit existing property owners.

[1] There is evidence that, when the UK Government announced a 'Stamp Duty holiday' during the financial crisis, the main effect of temporarily cancelling the tax was that house prices were bid up.

In relation to commercial property, properties in Scotland valued at between £150,000 and £300,000 pay a higher average tax rate than rUK counterparts, whereas transactions above £300,000 are taxed more highly in rUK than Scotland.

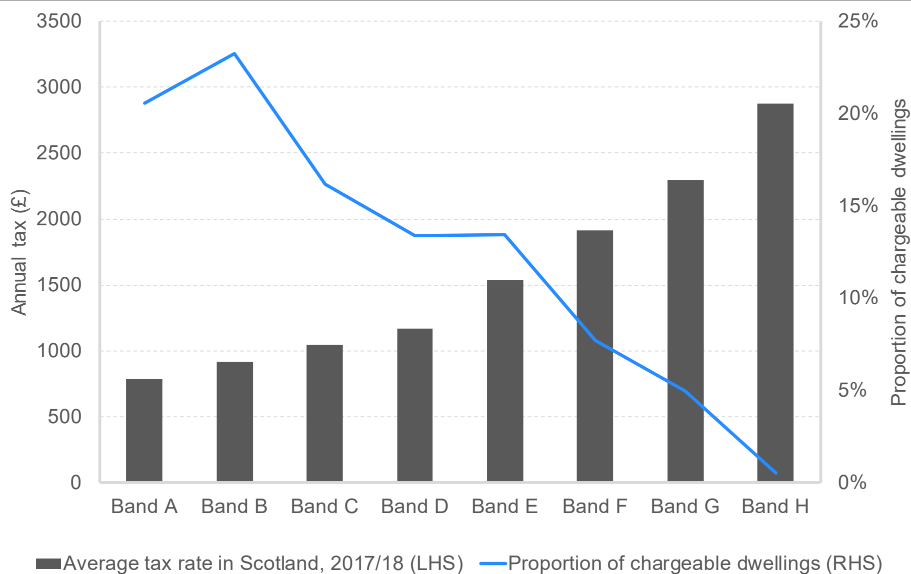
Council tax

Council tax is levied on domestic properties. Residential properties are assigned to one of eight bands (from A to H), based upon the value of that property at 1991 prices. Each council has some ability to determine the charge for Band D properties in their local authority area, with the tax for properties in all other bands being a proportion, fixed by the government, of that Band D charge. For example, Band A properties are taxed at 67% of a Band D property, whilst Band H properties are taxed at 245% of a Band D property.

Council tax has often been criticised because the tax levied is not particularly closely related to property value. This is partly because of the banding structure: the most expensive homes cost 15 times as much as the poorest, but they pay only 3.5 times as much council tax. The problem is exacerbated by the fact that properties in Scotland have not been revalued since 1991, meaning that many properties are in the 'wrong' band. (To see why this might be, imagine that two properties were valued as Band D in 1991, but one of these properties was in an area that has seen substantial price growth since, whilst the other has not; in this case both properties remain in Band D today, despite being valued differently in today's prices).

And whilst council tax rates are not closely related to property value, they are not well related to income either: there are relatively well-off households in Band A, and relatively poor households in Band H.

Chart 3: Council tax by band, and proportion of properties by band



Source: *Scottish Government*

Proposed replacements for council tax are not hard to find. Some argue to retain a similar structure, but to redefine the ratios between bands to make the system more progressive, and combine this with a property revaluation to ensure that properties are in the 'correct' band. Others argue that council tax should be replaced with a tax on property or land value. Others still have argued that a locally determined income tax would represent a fairer way to fund local services.

Each approach has different implications for distributional effects (winners and losers), administrative complexity, and the incentives and disincentives it creates (a local income tax might be easier to avoid for example than a property tax). And there is perhaps a bigger question in all this too, which is what proportion of local authorities' budgets are accounted for by council tax or whatever replaces it? (At the moment, around 12% of local authorities' income comes from council tax, on average).

In 2017/18 the Scottish Government did increase the ratio between the tax paid by the most expensive properties and the rest, a change which raised around £110m. But it rejected the idea of revaluation.

Indeed, whilst the limitations of council tax appear widely understood, incumbent politicians seem reluctant to pursue reform for fear of political consequences.

Business rates

Non-Domestic Rates (NDR) is a tax levied on the rateable value of business property. Non-Domestic Rates are collected by local authorities, paid into a central pool and then re-distributed. The tax rates and structure are set by the Scottish Government.

Some economists would question the fundamental rationale for business rates. Business premises are an intermediate input to the production process. Taxing the value of premises might disincentivise firms from making improvements to these premises. Rather than taxing the buildings, it would make more sense to tax the value of land on which the premises are based.

Notwithstanding this point, there are a number of issues associated with the design of NDR itself.

A number of types of businesses benefit from NDR reliefs. Most notably, the 'Small Business Bonus Scheme' provides rates relief for businesses occupying low-value properties. The rationale for the relief is to support the growth and sustainability of smaller businesses.

This is a laudable aim, but the relief is actually targeted at businesses occupying relatively low value premises, and these businesses may or may not be 'small' in the usually understood definition. The Small Business Bonus has been expanded in scope in recent years, so that by 2017/18, 100,000 of the 230,000 rateable premises in Scotland benefited from the relief, which cost the government in excess of £170m in lost revenues in 2014/15.

A relief in favour of low-value premises has the potential to distort economic activity in favour of more low-value properties and fewer high value properties. It is not clear that there is always a rationale for this – especially if businesses occupying low value premises are less likely to contribute to employment or productivity growth. There may be a case for supporting competition and variety in town centres, but is a discount on business rates the best way to achieve that goal?

Perhaps more fundamentally, evidence suggests that in the long-run, the impact of business rates reliefs is passed on to the owners of property via higher rents. Thus the ultimate beneficiaries of business rates reliefs schemes are likely to be property owners rather than the 'small businesses' that the scheme is intended to support.

In its 2018/19 budget, the government announced a number of reforms to NDR following the recommendations of the Barclay Review. These included a new relief designed to support business premises improvement called the 'Business Growth Accelerator' (a 12 month delay before rates are increased when an existing property is expanded or improved and also before rates apply to a new build property), as well as a number of new reliefs for organisations including day nurseries and hydro-electric schemes. These policies will cost the government around £70m in 2018/19.

However, whilst the Barclay Review recommended that the Small Business Bonus should be evaluated, and recognised the arguments for more fundamental reform of NDR generally, it also found that there was limited support among the business community for a radical departure from the existing system.

Air departure tax

Air Passenger Duty (APD) is a tax paid on passengers departing from UK airports. The amount of tax paid depends on the passenger's class of travel and their final destination (with long-haul flights being levied at a higher rate of tax).

The Scottish Government had put in place legislation to replace APD with the Air Departure Tax (ADT) from April 2018. However, the transfer of APD to the Scottish Parliament has been deferred, until a legal issue is resolved[2].

Notwithstanding this deferral of tax transfer, what do we know of the current Scottish Government's intentions for ADT? The government's proposals for ADT largely mirrored the structure of APD. But the government has a stated objective to reduce the burden of ADT by 50%, and eventually to abolish it.

The government argues that the loss of revenues from reducing rates of ADT will be at least partially offset by higher levels of economic activity in Scotland as a result of the policy. It argues that higher economic activity will be generated through: increased passenger throughput at airports as a result of the tax cut feeding through to prices; increased tourism activity within Scotland; the impacts associated with more aircraft and ancillary services being based in Scotland; and the impacts of greater connectivity on the productivity of Scotland's businesses.

However, the economic impact assessment also recognises the significant uncertainty associated with estimating the impacts of the tax policy. These uncertainties include: the extent to which airlines respond to lower taxes with new routes or by basing more aircraft and services in Scotland; the extent to which tax cuts feed through to prices; the responsiveness of passengers to price changes; and the degree to which the tax cut leads to additional overseas travel by Scottish residents.

Opponents of the government's ADT proposals argue that the costs of the policy in terms of lost revenues are unlikely to be offset by wider economic impacts. Moreover, the proposals are seen to run counter to the government's wider aspirations to reduce greenhouse gas emissions, whilst they have also been argued to be 'regressive', in the sense that those on higher incomes are likely to benefit more from the cuts than those on lower incomes, given that those on higher incomes are likely to travel by air more frequently.

VAT

From 2020/21, receipts from the first 10p of the standard VAT rate and the first 2.5p of the reduced VAT rate will be *assigned* to the Scottish budget[3]. With the current and standard rates of VAT at 20p and 5p respectively, this effectively means that around half of Scotland's VAT revenues will be assigned to the Scottish budget.

The assignation of revenues to the Scottish budget means that the Scottish budget will be dependent to an extent on revenues raised from VAT in Scotland. The rationale for this assignation is to strengthen the link between the performance of the Scottish economy and the Scottish budget.

But the Scottish Parliament will have no power to vary VAT rates, and thus there are no direct policy implications for the Scottish Government in relation to VAT design.

[2] Flights from the Highlands and Islands are exempt from Air Passenger Duty. However, replicating this relief in the new Air Departure Tax will require legal issues surrounding EU State Aid legislation to be resolved, and this has not been possible in time for April 2018.
[3] VAT will notionally be assigned to the Scottish budget in 2019/20, but this will be a transitional year and there will be no material effect on the budget until 2020/21.

Smaller taxes: Landfill tax and Aggregates levy

Landfill tax applies to all waste disposed of by way of landfill at a licensed site unless the waste is specifically exempt. Since Landfill tax was transferred to the Scottish Parliament in April 2015, the Scottish Government has applied the same rates as pertain to rUK.

In both Scotland and rUK, revenues from Landfill tax are forecast to decline in the coming years, as successively lower levels of waste are sent to landfill. In Scotland, the speed of this revenue decline depends on factors such as the rate at which new incinerator facilities come on stream, and the speed of progress towards a ban on biodegradable municipal waste sent to landfill by 2021.

The aggregates levy is a tax on the commercial exploitation in the UK of rock, sand and gravel. It was introduced as an environmental tax to encourage the recycling of aggregate. The levy is currently subject to a legal challenge in the European courts, and devolution will not take place until this has been resolved[4].

The power to create new taxes?

The Scottish Parliament also has powers to introduce new taxes in areas related to its devolution settlement. This means for example that it could probably introduce a new land tax in place of Council Tax, Business Rates and LBTT if it wanted. Or it could introduce some form of tourism tax, as has sometimes been mooted. However, the Scottish Parliament does require the approval of HM Treasury to establish new taxes, and the precise scope of what it could do is yet to be fully explored (the Welsh Government is consulting on ideas to introduce a Vacant Land Tax, a Social Care Levy, a Disposable Plastics Tax, and a Tourism Tax).

[4] The tax is intended to operate as an incentive to promote recycled aggregate by increasing the cost of first used aggregate. However the British Aggregates Association (BAA) disputes the effectiveness of the tax for this purpose, and argues that some of the tax exemptions effectively create issues of State Aid.

Modelling the impact of tax changes on the Scottish economy

As highlighted above, there is considerable debate about how tax changes might impact on economic activity both in the short and the long run. The Scottish Policy Foundation's model of the Scottish economy can be used to examine these issues and to estimate the scale of any economic impact from changes in tax policy. For details on the Foundation's model see our summary and video guide.

As part of the Foundation's investment in improving capacity to support policy development, this model is being extended to incorporate the new tax powers of the Scottish Parliament following the Smith Commission. To illustrate how the model can be used to help inform debate, we simulate the impact on the Scottish economy of a two percentage point increase in the effective income tax rate in Scotland.

How might such a change impact on Scotland's economy? Broadly speaking, there are two countervailing forces.

Firstly, there is likely to be a modest stimulus to demand. This is because an increase in taxes (and a subsequent rise in government spending) effectively represents a shift in spending from private to public consumption. But because government spending is less import-intensive the net impact is likely to be positive.

Secondly, if workers bargain over their take-home pay there is a negative competitiveness effect. If taxes rise workers feel worse off. In most cases, they are likely to attempt to restore their standard of living by bidding for higher wages from their employers. Migration flows into Scotland are also likely to be inhibited by lower take home pay. Combined these effects create an adverse competitiveness effect. The more open the economy the greater the adverse effects associated with this loss of competitiveness.

Negative competitiveness effects are likely to dominate positive demand effects over time in a highly open economy like Scotland.

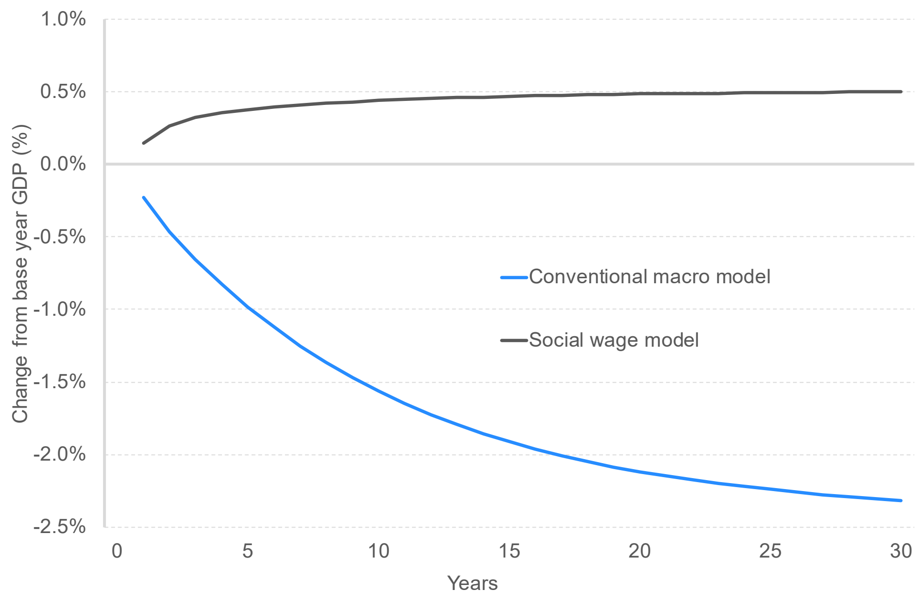
But within the competitiveness effect, another factor is crucial. If workers value the uplift in public spending, they may be willing not to bid up their wages to restore their take-home pay – whilst they have lost some private consumption they have gained better public services. Of course, in the limiting case, where the improved public services fully compensate for the loss of private consumption, the adverse competitiveness effect could be eliminated entirely. In this "social wage" case, the beneficial net demand stimulus associated with the fiscal expansion dominates.

Which effect will dominate in reality?

There is no hard evidence in favour of one scenario over the other – either from within the UK or internationally. But we can estimate the limiting cases.

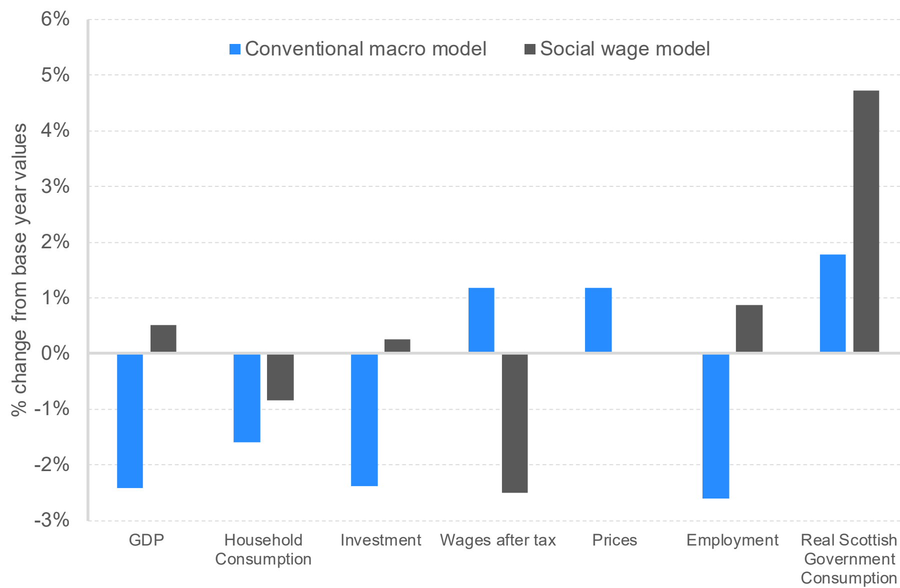
Charts 4 and 5 show the impact on the Scottish economy of a two percentage point increase in the effective income tax rate in Scotland.

Chart 4: Changes in GDP (%)



Source: *Fraser of Allander Institute*

Chart 5: Long-run changes in selected variables (%)



Source: *Fraser of Allander Institute*

We see that, under a conventional approach, an increase in income tax of this magnitude will reduce GDP by around 2.4% over the long-run. But under a full 'social wage approach' – that is, where workers value public goods just as much as they do private goods – the Scottish economy will expand slightly in the long-run.

What can we conclude from this analysis?

The modelling suggests that an increase in tax is likely to lead to a positive stimulus to demand but this will be overturned by a negative competitiveness effect. In short, an increase in taxation will reduce GDP in the long-run. This suggests that some other policy may be needed alongside any increase in income tax to help offset any negative impacts.

However, the modelling also suggests that there is a scenario where this can be overturned. This can occur if people value the public services that the tax increase is being used to fund. This explains why some countries can have much higher income tax rates than Scotland and the UK and still grow strongly. But the obvious question that arises from this is how likely it is that workers in Scotland will behave in such a way.

It also suggests that if increasing tax, policymakers need to be careful, not just to consider how much they intend to raise in revenue, but what they spend it on. If they can use the funds to spend on services that people value, then they can help mitigate any negative competiveness effect. Spend it less wisely – and on services that are valued less – then the likelihood of a negative hit to the economy increases.

Furthermore, some forms of public spending may have beneficial effects on the supply side of the economy that can mitigate the competitiveness effect of a tax rise. Public capital expenditure, such as that on improving transport infrastructure, may reduce business costs and stimulate the private sector. Also, some forms of what are classified as "current" public spending, such as major parts of education and health expenditure, may improve the productivity of the workforce and potentially offset any adverse effects of a rise in income tax used to fund the changes.

Conclusions

The Scottish Parliament now has substantial new tax powers. Soon around half of the Scottish budget will be determined by tax revenues raised in Scotland. This means that the performance of the Scottish economy now has a significant impact on the budget. Of, perhaps, greater interest for policymakers is how to best use these new tax powers.

The Scottish Government has already started to set tax policy differently to the UK as a whole, with its own policies on LBTT and income tax. So far, the changes have been relatively modest – although the 2018/19 budget has arguably signalled a more ambitious approach to differentiating Scottish income tax from the rest of the UK than many predicted.

To help work through the potential implications of such policies, it is possible to use the Scottish Policy Foundation's macroeconomic model of the Scottish economy.

If you are interested in putting forward a policy proposal and/or use the Scottish Policy Foundation's model to assess its possible impacts, please contact mail@scottishpolicyfoundation.org.