Poverty Alliance Briefing 23

Devolved Taxation in Scotland

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Introduction

The Scottish Government has increasing powers to vary tax rates in Scotland. In addition to having full control over local property taxes (Council Tax and Non-Domestic rates), Stamp Duty was transferred to Scotland in 2015/16 and replaced by the Land and Buildings Transaction Tax. From 2016/17 the Scottish Government will gain partial control over income tax in Scotland, including the ability to set the so-called 'Scottish Rate of Income Tax' (SRIT). And in the relatively near future, virtually full control over income tax will be devolved to the Scottish Parliament.

This briefing paper, written by David Eiser, Research Fellow in Economics at the University of Stirling and the Centre on Constitutional Change, sets out some of the options for and implications of reforming devolved taxation in Scotland. We hope this paper will inform the debate over how we use taxation powers to address poverty and inequality in Scotland.

The Scottish rate of income tax

As of April 2016, the Scottish Government gains partial control over income tax in Scotland, through the so-called Scottish Rate of Income Tax (SRIT). As of April 2016, each income tax band in Scotland will be reduced by 10p. It will then be up to the Scottish Government to decide how much of this to add back on. If the Scottish Government sets the SRIT at 10p, then income tax rates in Scotland will be no different from those in the rest of the UK, and the Scottish Government will retain the revenue raised from the 10p band. But the Scottish Government could if it wanted set a SRIT at less, or more than, 10p. If it sets a SRIT of 11p for example, then income tax rates in Scotland would be 21p on the basic rate, 41p on the upper rate, and 46p on the additional rate, and the Scottish Government would retain whatever additional revenues were raised.

Although these powers do give the Scottish Government powers to raise additional revenue from tax, they do not provide the Scottish Government much leverage to influence the income distribution. The SRIT is a ‘flat-rate tax’, meaning that each rate must be changed by the same amount. So the Scottish Government could increase the Additional Rate by 1p to 46p, but only by simultaneously increasing the upper Rate by 1p to 41p, and the basic rate to 21p. Similarly it can cut the basic rate to 19p, but only by simultaneously setting the Higher Rate at 39p and the Additional Rate at 44p.

In his Draft Budget for 2016/17, John Swinney set the SRIT at 10p, meaning that income tax rates in Scotland will continue to be 20p, 40p and 45p on the basic, upper and additional rates. Had he set the SRIT at 11p, Mr. Swinney would have raised around £420m additional revenue for his budget. His argument for not raising the SRIT to 11p is that such an increase would hit those with the lowest incomes disproportionately hard.

The charge that the SRIT is regressive is often made but is not quite correct. The claim is made on the basis of the change in marginal rates of taxation. For example a basic rate taxpayer sees their tax rate increase from 20p to 21p, an increase of 5%, whereas an upper rate taxpayer sees their marginal tax rate increase from 40 to 41p, an increase of 2.5%. This means that, following a 1p increase in SRIT, basic rate taxpayers see the *amount of tax they pay* increase by 5%, whereas those earning above the upper rate face a smaller percentage increase in the amount of tax they pay.

So, when John Swinney said in his Budget statement 'By its nature, exercising that power [increasing the SRIT] would have a disproportionate effect on the *amount of tax paid* by the taxpayers on the lowest incomes', he is correct (as long as, by 'taxpayers on the lowest incomes' he is referring to anyone earning less than the Upper Rate threshold, i.e. £43,000).

However, in assessing the progressivity of an increase in SRIT, it is more relevant to consider the *change in after tax income*, not the change in the amount of tax paid. What is critically important in this respect is the role of the Personal Allowance in influencing the average tax rate.

The Personal Allowance is now over £10,000[1]. Clearly, anybody with income less than £10,000 pays no income tax at all, and is not affected by an increase in the SRIT. Somebody with an income of £12,000 (equivalent to working full-time on the minimum wage) pays tax on 17% of their total income (the bit above £10,000). An increase in the SRIT from 10p to 11p results in a fall in his after tax income of just 0.2%, from £11,600 to £11,580. Somebody earning £23,000 (the median Scottish wage for all workers) pays income tax on 57% of their income. Because this person is paying tax on a greater proportion of their income, her after tax income falls by 0.6%, from £20,400 to £20,270. As income increases beyond the Personal Allowance, a greater proportion of that income is subject to tax, and thus to an increase in the SRIT. So somebody earning £50,000 sees their after tax income fall by 1%, from £40,400 to £40,000. And for those earning above £100,000, the Personal Allowance is gradually withdrawn. This means that somebody earning £150,000 would pay the additional 1p SRIT on all of their income – her after tax income would thus fall by 1.5%.

Now people might still object to a rise in the SRIT on the grounds that a 0.2% cut in income for the poorest households might cause those households greater financial difficulty than a 1.4% cut in disposable income might pose for the richest households. But to say that a rise in the SRIT would be regressive is not quite true.

The Smith Commission proposals: full devolution of income tax

In the longer-term, the Scottish Government will gain almost full control over income tax, including the ability to vary rates and thresholds without constraint, if the recommendations of the Smith Commission are implemented. It is not particularly obvious how this power might be exercised to alleviate poverty given that the lowest earning 40% of adults (and almost 20% of the lowest paid workers) already face no

[1] It is actually £10,600, but in this paragraph I assume it is £10,000 so that the examples are easier to follow.

income tax liability; thus the case for further rises to the Personal Allowance is not as clear-cut as politicians sometimes imply.

Regarding inequality more generally, the Scottish Government would have the ability to increase tax rates on those with the highest incomes, without increasing the basic rate. John Swinney has hinted that he might be inclined to increase higher rates of income tax only, when the Scottish Government gains the power to do so in future. A rise in the Higher Rate of income tax, from say 40p to 41p, would indeed protect those with incomes less than £43,000 from tax rises. But it would generate far less revenue than a rise in the SRIT, (probably around £60m). Increases in Higher Rate tax generate relatively little additional income, because there is less total income to tax!

Furthermore, it is not clear that concentrating tax increases on a relatively small subset of income earners will be politically any easier than increasing the SRIT. A rise in the SRIT could in theory be framed as a broad-based measure to reverse austerity, whereas a rise in higher tax rates will always be attacked as an attempt to soak the rich. And the more that tax rises are concentrated on the highest earners, the greater the risk that such policy might induce some high-income earners to relocate themselves (or their earnings) to the rest of the UK, depriving the Scottish Government of tax revenues.

So whilst it is true that increasing the SRIT would not have been particularly progressive, it would have raised over £400m; concentrating tax increases on those with higher incomes would undoubtedly be more progressive, but might not raise as much revenue. The question of how income tax rates should be set thus represents a complex trade-off between revenues, redistribution and behavioural incentives.

The Scottish Government's Council Tax Freeze and scope for reform

The Council Tax freeze has been a flagship policy for the Scottish Government since 2008/9. The average Band D Council Tax in 2015, at £1,149, is around £200 per year less than it would be if council tax had increased in line with inflation since 2008.

Council tax is seen as unfair because it is neither well related to property value (it is charged at a lower percentage of property value for high value properties than for low value properties), nor to income.

The Council Tax freeze is sometimes justified on the grounds that raising Council Tax would be regressive. This is argument is partially true. If there was no Council Tax Reduction (CTR), then Council Tax itself would be a very regressive tax, with poorer households paying a higher proportion of their income in tax than richer households. CTR is designed to offset the regressive nature of council tax. But take-up rates of CTR are quite low. Around a third of eligible households do not claim. This non take-up of CTR means that council tax remains regressive across the whole of the income distribution. Because of this, a rise in Council Tax hurts poorer households proportionately more than richer households; and thus a freeze, which is equivalent to a real terms cut, is inequality reducing, as poorer households benefit proportionately more than richer households. Thus, although the Scottish Government could make the case that its council tax freeze is a progressive policy, this outcome occurs in part because of low take-up of CTR.

For each year that Council Tax is frozen, it costs the Scottish Government an additional £70m in compensation payments to local authorities. Thus the cost to the Scottish Government of freezing Council Tax at 2008/9 levels is now around £0.5bn per year. Rather continuing the freeze, it would be far more sensible to reform local taxation so that it is both fairer and (potentially) raises more revenue.

There have long been calls for Council Tax reform. In December 2015, the Commission on Local Tax Reform, a cross-party group of MSPs, Councillors and other stakeholders, delivered its long awaited report into options for reform of local taxation in Scotland.

The Commission made clear its view that Council Tax should be replaced with some other form of tax (rather than charges for specific services). And the 'predominant view' of the Commission was that any reform of local tax has to include a fairer tax on domestic property, combined with a more progressive system of reliefs for those with low income. The Commission is also of the view that local authorities should have greater autonomy and flexibility to vary local taxation rates in order to support a reinvigoration of local democratic participation.

However, the Commission did not go so far as to recommend specific alternatives to Council Tax. Instead, the report considers the advantages and disadvantages of different forms of local taxation, including taxes on property, land and income. It describes the likely implications of these different types of tax – including their impact on different types of household, the extent to which they will provide a stable source of local government revenue over time, the likely administrative costs, and the extent to which they might influence behaviour in both desirable and undesirable ways.

By avoiding the trap of recommending a specific scheme that could then be dismissed out of hand, the Commission hopes that its report will stimulate wider debate that can eventually pave the way for cross party consensus on a way forward. But many would have hoped that a cross-party group would have been able to make some stronger recommendations about what should or should not replace Council Tax. The fact that it hasn't shows how contentious the issues are.

These political barriers to reform are not new of course. In 2006 the Burt Review of local taxation in Scotland "A Fairer Way" recommended the replacement of Council Tax with a tax of 1% of property value, but was swiftly rejected by then First Minister Jack McConnell. And in 2009, the SNP minority government had to drop its manifesto commitment to replace Council Tax with a 3% local income tax when the Budget was defeated.

My own view is that local taxation should be concentrated on immovable land and property. A relatively simple alternative to Council Tax would be to replace it with a tax that is proportional to property value. For example, a tax of less than 1% of the value of property is likely to be revenue neutral for the government. It could be combined with a system of benefits or reliefs for those on low incomes. However, I would argue that income should be taxed at a Scotland-wide level by the Scottish Government, given the administrative and efficiency issues around the collection of such taxes.

How much the Commission's report moves us forward is a moot point. The limitations of Council Tax have been understood for some time, but politicians have been reluctant to pursue reform for fear of the political consequences. By widening the debate around alternatives and their implications, the Commission's report moves us one small step closer to the end of Council Tax. But in some ways the end of Council Tax seems just as far away. It will be interesting to see what the parties propose in their forthcoming manifestos.

Other tax powers being devolved to the Scottish Parliament

Other than its powers over local taxation and income taxation, the Scottish Government's powers to raise revenue and influence the income distribution are relatively small.
In 2015, Stamp Duties were transferred to Scotland. The Scottish Government replaced Stamp Duties with the new 'Land and Buildings Transactions Tax' (LBTT). The LBTT does represent an improvement on the previous Stamp Duty system, setting a more progressive rate structure. The LBTT raises about £400m for the Scottish Government.

In his Draft 2016/17 Budget, Mr Swinney followed the policy announced by George Osborne in the Autumn Statement, and has imposed a 3% premium on LBTT rates for buyers of second homes and buy-to-let properties. This might be symbolic of a commitment to inclusive growth, but it will not raise substantial revenue, nor make a major difference to problems of housing affordability. And the LBTT remains a tax on transactions, which is inefficient (transactions taxes discourage people from making beneficial exchanges). If the Scottish Government reformed property taxation more fundamentally, it could eliminate the LBTT entirely.

The 2016/17 Budget also announced a review of Non-Domestic Rates (business rates) in the next parliament. This was welcomed by business organisations who – after nine years of a Council Tax freeze – argue that they are making a disproportionate contribution to the Scottish Government's revenue growth. Looking further ahead, the Smith Commission also recommended the devolution of Air Passenger Duty (APD) to Scotland, and the assignment of half of VAT revenues raised in Scotland to the Scottish Government. The Scottish Government has announced an intention to half the rate of APD by 2019/20, a decision that seems hard to justify on either environmental or economic grounds (it seems unlikely that a halving of APD rates will stimulate sufficient additional air passenger numbers to make up for the lost revenue). The assignment of VAT to the Scottish Government does mean that the Scottish budget will be more closely linked to the performance of the Scottish economy, but the Scottish Government will have no power to vary VAT rates or allowances.

Conclusions

The Scottish Government now has increasing scope to use taxation levers both to vary the size of its own budget, and to influence the progressivity or fairness of major property and income taxes.

Politically however, there is often much resistance to tax reform from the political incumbents. Opposition parties criticised John Swinney's 2016/17 Budget for its inertia – council tax frozen again, new income tax powers unused, and the only reform of note was a mimicking of George Osborne's levy on purchasers of second homes and buy-to-let properties.

Details of the parties' manifesto commitments on tax are beginning to emerge. Labour and the Liberal Democrats have both suggested a preference for adding 1p to the SRIT, whilst the Conservatives are exploring the option of reducing the upper rate of tax from 40p to 30p for some taxpayers, once full devolution of income tax has taken place. Whatever one thinks of the merits of these policies individually, the fact that Scottish politicians are keen to debate the use of the new powers is a positive outcome.