This note considers the potential impact on revenues associated with an increase in the additional rate of income tax in Scotland from 45p to 50p, to be levied on non-savings, non-dividend income.

**How many people are currently liable for the additional rate of income tax in Scotland?**

Table 1 below summarises HMRC estimates\(^1\) of the number of additional rate taxpayers in Scotland and the UK in 2015-16, and their estimated contribution to overall tax revenues. This highlights that:

- In 2015-16, 17,000 adults in Scotland paid the additional rate of income tax. This corresponds to approximately 0.7% of taxpayers in Scotland. In the UK as a whole the proportion of additional rate taxpayers is 1.1%.
- Therefore compared to the UK as a whole, there are proportionately fewer people in Scotland who pay the additional rate of income tax.
- In 2015-16, Scotland accounted for 5.1% of additional rate income taxpayers in the UK, significantly less than its share of the UK population (8.3%).
- Additional rate taxpayers in Scotland contributed nearly 14% of all Scottish income tax revenues. This means that the behaviour of a relatively small number of individuals may have a significant impact, positive or negative, on overall Scottish income tax revenues.

**Table 1: Summary of Additional Rate Taxpayers, 2015-16**

<table>
<thead>
<tr>
<th>Additional Rate Taxpayers, 2015-16</th>
<th>Number ('000s)</th>
<th>% Share of Total Taxpayers</th>
<th>% Share of Total Tax Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scotland</td>
<td>17,000</td>
<td>0.7%</td>
<td>13.7%</td>
</tr>
<tr>
<td>UK</td>
<td>332,000</td>
<td>1.1%</td>
<td>27.3%</td>
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</tbody>
</table>

Source: HMRC and Scottish Government analysis.

Note: Table represents all taxpayers and all income, except % share of tax revenues in Scotland which represents NSND income only, and % share of tax revenues in UK which represents earned income only.

- Furthermore, additional rate taxpayers in Scotland also have lower earnings, on average, than those in the UK as a whole. Average earnings of additional rate taxpayers in Scotland were £310,000 in 2010-11, compared to £370,000 in the UK as a whole.

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Behavioural impacts

There is considerable uncertainty associated with estimates of the extra tax revenue which could be raised by increasing the additional rate of income tax in Scotland. This reflects the uncertain, and potentially large, behavioural response which could be expected to impact on the yield from the policy.

Behavioural responses – the tendency for taxpayers to change their behaviour in response to tax changes - can be particularly large for high earners as they have both greater incentives and opportunities to restructure their finances to minimise their tax liability. Divergent rUK and Scottish income tax rates may create new incentives for behaviour change, such as artificially shifting income to or from the rUK or migrating into or from Scotland, given the relative ease with which taxpayers could make changes that are internal to the UK.

There is a range of international empirical studies to estimate how responsive taxpayers are likely to be to tax changes. Where taxpayers are estimated to be highly responsive to tax changes then they will change their taxable incomes by a large amount following any change in the tax rate.

To measure this responsiveness many of the studies produce taxable income elasticity (TIE) estimates.²

The evidence base suggests that taxpayers' responsiveness to tax changes varies depending on their level of income. For example, there is agreement across empirical studies that top earners tend to exhibit the highest behavioural response (i.e. they will have a higher taxable income elasticity). However, there is substantial variation in the size of this response.³ In addition, it is likely that the results may be country-specific to some extent.

Whilst the literature provides a broad indication of the range within which the TIE of Scottish taxpayers is likely to fall, there are particular uncertainties related to differential tax policy between Scotland and the rUK.

On the one hand, behavioural effects between Scottish and rUK taxpayers may be even more significant than standard assumptions because labour mobility between Scotland and the rest of the UK could be larger than between the UK and, say, the rest of Europe. This is because there are no cultural or language barriers and many individuals have much closer ties with the rest of the UK and may therefore relocate easily. In addition, many top rate taxpayers may be able to choose their residency within the UK, particularly if they are employed or working in UK-wide businesses. It would also be possible for individuals to live in England but continue to work in Scotland or vice versa. In addition, instead of migrating physically, high-income Scottish taxpayers could move their residence by rearranging their domestic affairs – for example by deciding to spend more time at a London flat than in an Edinburgh house, and making the flat their base.

² The TIE estimates “the percentage change in total taxable incomes in response to a one per cent change in the net-of-tax rate (the proportion of each additional pound earned received by the individual after tax)” (HMRC, 2012, page 14).

On the other hand, income tax in Scotland will apply to non-savings non-dividend (NSND) income only. Since this is largely income from employment, there are fewer opportunities for individuals to artificially minimise their tax liabilities compared to income from savings and dividends. Therefore, for those serving the Scottish market or based in Scottish institutions, it may be more difficult to engage in behaviours that reduce their Scottish tax burden. This could reduce the scale of the potential behavioural response.

In a UK-specific study, the Institute for Fiscal Studies (IFS) estimated the elasticity of top income earners at 0.46, similar to HMRC’s central estimate of 0.48. However, as behavioural effects from Scottish and rUK taxpayers are likely to be subject to a wider degree of uncertainty, as described above, a wider range of behavioural responses, from a range of studies, needs to be considered when modelling the revenue impact for Scotland.

**Estimating the impact of a 5p increase in the additional rate of income tax**

Table 2 below shows the illustrative estimates of the expected impact on non-savings, non-dividend income tax revenues in Scotland were there to be a 50p additional rate in Scotland and a 45p additional rate in the rUK in 2017-18. The table includes adjusted revenue estimates which take account of different behavioural assumptions:

- “Static” shows the impact without any behaviour response.
- Assuming a low behaviour response – on the basis that the response falls in the lower range of the elasticities surveyed - net additional revenues are estimated to be £50m in 2017-18 for an additional rate of income tax of 50p.
- Assuming significantly higher tax elasticities - on the basis that migration and other effects may occur more easily between Scotland and rUK than between the UK and overseas jurisdictions – a potential loss of revenues for the Scottish Government of £30m is estimated. This could be due to, for example, a relatively small number of very high income individuals leaving Scotland, with the transfer of all of their tax contributions to the rest of the UK.
- It should also be recognised that the behaviour effect will last over a period of time, with potentially more significant impacts resulting in decisions not to migrate to Scotland, and therefore potentially reducing future growth in tax revenues.

<table>
<thead>
<tr>
<th></th>
<th>Static</th>
<th>Low Behaviour</th>
<th>High Behaviour</th>
</tr>
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<tbody>
<tr>
<td>2017/18</td>
<td>£110</td>
<td>£50</td>
<td>-£30</td>
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5 HMRC (2012, page 40).

6 Note that if the UKG increased the additional rate above 45p, the potential gains/losses would become lower.

7 The table assumes a TIE of 0.35 (in the low behaviour scenario) and 0.75 (in the high behaviour scenario) to create a range of potential revenue figures. This allows for potentially greater behaviour than in the UK, but is still less than some of the values estimated by some studies.
Policy risk

Given the high average tax liabilities of additional rate taxpayers, the overall change in revenue could be influenced by changes in the tax liabilities of a relatively low number of taxpayers. For example, if 1,000 (6%) additional rate taxpayers in 2017/18 reduced their tax liabilities to zero, out of an expected additional rate taxpayer population of 18,000, this would result in the policy change raising no extra revenue. In the high behaviour scenario where there would be revenue loss of £30m this would be caused by 1,300 additional rate taxpayers leaving Scotland, or 7% of the additional rate taxpaying population.

For someone earning £1 million per year an increase in the top rate of tax to 50p would cost them an extra £42,500 per year, or around 4% of their income. If such a taxpayer either left Scotland, or in some other way managed to avoid paying income tax in Scotland, the loss in revenues in Scotland would be almost £440,000. This highlights the relatively low impact on the individual but the high risk to revenues.

The distribution of incomes of additional rate taxpayers is concentrated on larger numbers of individuals with incomes above but close to £150,000, with a long ‘tail’ of smaller numbers of individuals earning much larger incomes. The larger the income the more tax an individual is liable for, and as such a single very high income earner will account for the same tax receipts as a larger number of less high income earners. The table below sets this out for 2017/18 tax liabilities.

<table>
<thead>
<tr>
<th>Individual additional taxpayer’s income (£)</th>
<th>155,000</th>
<th>200,000</th>
<th>500,000</th>
<th>1,000,000</th>
<th>5,000,000</th>
<th>10,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total tax paid by individual (£)</td>
<td>55,800</td>
<td>78,300</td>
<td>228,300</td>
<td>478,300</td>
<td>2,478,300</td>
<td>4,978,300</td>
</tr>
<tr>
<td>Number of additional taxpayers required at this income level to equal tax liability of £10m income</td>
<td>89</td>
<td>64</td>
<td>22</td>
<td>10</td>
<td>2</td>
<td>1</td>
</tr>
</tbody>
</table>

There is therefore likely to be a significant revenue risk associated with increases to the Scottish additional rate of income tax above that applicable in the rest of the UK.

A further risk will impact on future tax revenues where an increased additional rate of tax reduces the attractiveness of locating in Scotland in the future and reduces the potential economic and tax growth rates.

HMRC’s enforcement and compliance processes ensure that individuals do not manipulate their address without genuinely relocating residence from Scotland. Some of the behaviour effects will be from legitimate migration from Scotland, either for an individual to commute to Scotland from outside Scotland, or to simply fully relocate residence and employment away from Scotland.

How behavioural effects are dealt with in the fiscal framework introduces a further element of uncertainty as any additional tax receipts which would be generated by a policy change to the additional tax rate, either in Scotland or the rest of the UK, may be challenged by the other Government.