Fiscal Commission Working Group

Principles for a Modern and Efficient Tax System in an Independent Scotland
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Foreword: Crawford Beveridge

It is a pleasure to present to Scottish Ministers the next report of the Fiscal Commission Working Group.

Back in February, the Working Group published their first report, a comprehensive and detailed overview of the Scottish economy and proposals for a robust macroeconomic framework in an independent Scotland, workable from day one of independence.

At the beginning of October, the second report of the Working Group set out how the fiscal framework for an independent Scotland could be designed to ensure that it takes account of the distinct characteristics of oil and gas tax revenues. The establishment of both a short-term stabilisation fund and a long-term savings fund could help to maximise the economic opportunity that Scotland’s oil and gas wealth presents and ensure that it provides a lasting benefit for future generations.

To further illuminate the responsibilities and opportunities that would fall to Scotland with independence, the Working Group sets out in this paper the principles of a modern and efficient tax system in an independent Scotland. This work is intended to aid and inform the Scottish Government as it takes forward a programme of work to scope out and design an efficient and effective tax system as part of a framework that delivers longer-term stability and sustainability.

Taken together with the paper on fiscal rules and fiscal commissions, and previous work, the Working Group provides a clear blueprint for a comprehensive fiscal framework for an independent Scotland.

Let me stress, this paper is not about particular tax rates, reliefs or allowances which should be established in an independent Scotland. These are clearly decisions for the elected governments of an independent Scotland.
What this work does, is to detail a set of clear principles – simplicity, stability, neutrality, and flexibility – which, with full control over the tax system, we recommend the Scottish Government and Scottish Parliament should follow to meet its objectives in the most effective manner.

These matters are of crucial importance to all countries, and lie at the heart of government policy. Policies on taxation effect each and every person and business across Scotland.

While focusing on taxation, the paper makes clear that a whole system approach is required in formulating government policy, particularly concerning taxation and welfare. The Expert Working Group on Welfare recently published their report on welfare in the context of constitutional change, and we strongly recommend that the government considers that paper, and this, alongside one another.

Small countries are not just scaled down versions of larger countries, and utilising Scotland’s size through streamlined institutions and decision making would facilitate a comprehensive approach which allows a clear focus on the objectives of taxation and welfare across the entire public sector and beyond.

Getting this correct would provide Scotland with a significant international advantage – and crucially a tool for promoting economic growth, competitiveness and tackling inequalities across Scotland. With full control of taxation and welfare, the systems could be tailored to suit the specific characteristics of Scotland.

It is undisputed that there is significant room for improving in the UK tax system that Scotland would inherit. Over many years, the accretion of increasingly complicated provisions has left a system which is complex and lacking a clear set of guiding principles.

There is no doubt there will be certain practical issues to consider in setting up a Scottish tax system, but this should not limit ambition and design.

Recent high profile examples have also highlighted some of the challenges globalisation has brought in collecting revenues from companies operating across multiple borders.
Our work stresses the importance of ensuring individuals and companies pay their fair share – and that moves to make Scotland a more competitive environment must be about attracting genuine economic activity and creating not only jobs, but good jobs which is the most effective way to alleviate poverty across Scotland.

Again, I would like to express my gratitude to my fellow members of the Working Group – Professor Andrew Hughes-Hallett, Professor Frances Ruane, Professor Sir James Mirrlees and Professor Joseph Stiglitz – for the considerable effort and expertise that they have continued to offer this project.

With the publication of this report, alongside our previous and forthcoming work, the body of quality analysis is growing substantially, and I would hope this is met by a similar level of dialogue and engagement on the economic future of Scotland from all concerned.

Crawford Beveridge CBE
Chair, Council of Economic Advisers
November 2013
Fiscal Commission Working Group Membership

Membership is drawn from the First Minister’s Council of Economic Advisers. The Chair is Crawford Beveridge CBE.

Crawford Beveridge CBE (Chair) – Crawford Beveridge is a technology industry veteran with more than 35 years of experience. This included working as an Executive at Sun Microsystems for over 15 years. In 1991, Beveridge left Sun to become Chief Executive of Scottish Enterprise. Beveridge returned to Sun in April 2000 as Executive Vice President of People and Places and Chief Human Resources Officer. In addition to being the Non-Executive Chairman of the Board of Autodesk, Beveridge is Chairman of Scottish Equity Partners Ltd, and a Non-executive board member of eSilicon and Iomart Group PLC. He was awarded a C.B.E. in the New Years Honours list in 1995.

Professor Andrew Hughes Hallett - Professor of Economics and Public Policy at George Mason University in the US, visiting Professor at Harvard University and Professor of Economics at the University of St Andrews. Professor Hughes Hallett specialises in international economic policy and has acted as a consultant to the World Bank, the IMF, the Federal Reserve Board, the UN, the OECD, the European Commission and central banks around the world.

Professor Sir James Mirrlees – Professor Emeritus at Cambridge University and distinguished professor-at-large at the Chinese University of Hong Kong. In 1996 Sir James was awarded the Nobel Prize for his work on economic models and equations about situations where information is asymmetrical or incomplete. In 2010, he led the Mirrlees Review of taxation which examined the principles and characteristics of a good tax system for open developed economies in the 21st century.

Professor Frances Ruane – Professor Ruane is Director of Ireland’s Economic and Social Research Institute and Honorary Professor of Economics at Trinity College, Dublin. She has published widely in the area of international economics and industrial development.

Professor Joseph Stiglitz– Professor Stiglitz is Professor of Economics at Columbia University. He won the Nobel Prize in Economics in 2001 and was a member of the US Council of Economic Advisers (CEA) from 1993-95, serving as CEA Chair from 1995-97. He was Chief Economist and Senior Vice-President of the World Bank from 1997-2000. In 2009 he was appointed by the President of the UN General Assembly as Chair of the Commission of Experts on Reform of the International Financial and Monetary System.
Executive Summary

- Under the current constitutional framework, the Scottish Parliament is responsible for around 7% of all taxes raised in Scotland (including a geographical share of oil). This will rise to 15% with the introduction of new responsibilities flowing from the Scotland Act 2012.

- Independence would provide full control of all taxation and expenditure levers in Scotland with autonomy over tax design, collection and implementation. The requirement to establish a new tax system post-independence provides an opportunity to re-examine the tax framework as a whole and to design a system based upon specific Scottish circumstances, preferences and principles but also with modern technology and data collection in mind.

- A re-designed Scottish tax system could represent a major competitive advantage, offering a more robust and efficient tax system than key competitors. A number of objectives will need to be considered:
  - Designing a modern and efficient system
  - Delivering an effective macroeconomic framework
  - Promoting competitiveness, economic growth and tackling inequalities
  - Implementing and managing the transition to full autonomy
  - The European and international context

- A tax system which follows the principles of simplicity, neutrality, stability and flexibility, will minimise administration and compliance costs, maximise tax-take and boost investment and growth.

- To follow these principles, a balance will be required between the different broad methods of taxation – income, expenditure and wealth taxes – and how, within these taxes, individual elements are structured and developed.

- As the report makes clear, the tax system – in conjunction with other policies such as welfare and general public service provision – can be used to shape outcomes that reflect the socio-economic vision of a country. It also plays a crucial role in any macroeconomic framework.

- Transition to a new tax system will take time. The UK tax system is complex and costly, and studies have shown there is considerable room for improvement in its design and operation. It is vital that such a transition is handled smoothly. The Scottish Government should
develop a clear plan for how it will migrate, over time, towards the development of its own modern Scottish specific tax system.

- A framework for decision making should be built around clear objectives and principles, with changes analysed on a full cost-benefit basis over both the short and long-term.

- This report reviews the evidence and literature on tax collection and considers the experiences of other countries and relates these to the Scottish context.

- A series of recommendations are provided for Scottish Ministers to consider.
Summary of Recommendations

**Designing a modern tax system**

- A **Scottish system should be clear and principles based** – any exemptions and tax reliefs should be carefully targeted
- The government should set out and develop a transparent **framework for policy making** – based around clearly defined objectives and principles of a good system, with decisions based on a robust and analytical assessment of costs and benefits
- A **Scottish system should be built to ensure that there is a whole view approach to consumer and business taxation** – including the use of unique identifiers to aid simplicity, transparency and compliance
- Scotland should look to have an **efficient government structure and institutional landscape** to maximise the effectiveness and efficiency of tax policy design and tax collection and take advantage of links with wider socio-economic policies

**Delivering an effective macroeconomic framework**

- The Scottish Government should **consider tax policy design as part of the wider fiscal and macroeconomic framework**, including the use of fiscal rules and the establishment of an independent fiscal commission
- **High levels of integrity and transparency** should be brought to the system through the establishment of a **tax policy forum** – using independent experts would ensure that vested interests did not unduly influence design

**Promoting competitiveness, economic growth and tackling inequalities**

- The Scottish Government should **design a tax system built around Scottish circumstances and preferences to help increase productivity and economic growth** while meeting the needs of the people of Scotland
- The **tax and welfare systems are key levers for tackling inequality** – both are strongly interlinked and should be considered as fundamentally part of the same system. Welfare and tax policy should therefore be developed in tandem to ensure policy integration and alignment
- Appropriate tax rates maximise receipts by creating the optimal level of economic activity and revenue raising potential. The Scottish Government **should assess the optimal balance of tax rates and bases for key taxes**, such as business and employee taxes, and levels of government spending.
- An **open and consultative approach** with the industry, independent experts, employer groups, and the general public, should be adopted when designing and reviewing the effectiveness of tax administrative policy to ensure the system is comprehensive, inclusive and maximises compliance
Transition and implementation

- The Scottish Government should build upon the experiences and lessons from the implementation of the tax powers in the Scotland Act 2012 to assist with the transition and implementation of further new powers.

- The government should focus on identifying key priorities and consider what can practically be achieved by the following milestones:
  - Independence day;
  - The short run (e.g. initial 5 years following independence);
  - Medium to long run (e.g. beyond 5 years).

- The Scottish Government should build skills and capacity over a carefully planned transition period – but should also communicate clearly and early on the direction of travel it intends to take.

European and international context

- The government should put the issue of globalisation at the heart of its tax system - including how to tax modern multinational companies and considering how best to collect tax in a world of international supply chains and e-commerce. International agreement is critical to ensuring companies pay the appropriate level of taxation and the government should work with key international partners to ensure the fair collection of taxes due.

- As part of this, the government should also use any new influence to support international bodies – including the EU and OECD – in their drive for greater tax cooperation, transparency and collection.

- The government should liaise with other governments, including the UK, around defining and measuring core elements of the tax system, including what constitutes taxable income. This could minimise compliance burden, ensure fairness and avoid inefficient shifting of activities for tax purposes, particularly across the Sterling Zone. Crucially, tax rates, thresholds, and allowances would remain the domain of the separate jurisdictions.
1. **Introduction**

**Background**

1.1 The Fiscal Commission Working Group has been tasked with overseeing the detailed technical work being taken forward by the Scottish Government to design a robust macroeconomic framework for Scotland post-independence.

1.2 The first report of the Working Group was published on 11 February 2013\(^1\).

1.3 The Working Group noted that independence would provide a substantial step change in the economic, financial and social policy levers open to future Scottish Governments.

1.4 A number of detailed recommendations were put forward by the Working Group to the Scottish Government, covering issues including monetary stability, financial stability and sound fiscal management.

1.5 The second report of the Working Group was published on 02 October 2013\(^2\), outlined how the incorporation of a short-term stabilisation fund and long-term savings fund into Scotland’s fiscal framework could help maximise the economic opportunity that Scotland’s oil and gas presents.

1.6 This paper is the next in the series of reports to be prepared by the Working Group.

**Fiscal Policy**

1.7 A key recommendation of the first report was that the Scottish Government should look to establish a framework that delivered long-term sustainability through effective management of the public finances. Of critical importance is the need to promote economic growth and resilience, whilst at the same time tackling inequalities.

\(^1\) The first report of the Fiscal Commission Working Group is published on the Scottish Government website and is accessible through the following web link: [http://www.scotland.gov.uk/Publications/2013/02/3017](http://www.scotland.gov.uk/Publications/2013/02/3017)

\(^2\) Fiscal Commission Working Group, Scottish Stabilisation and Savings Fund: [http://www.scotland.gov.uk/Publications/2013/10/7805](http://www.scotland.gov.uk/Publications/2013/10/7805)
1 Introduction

1.8 It was recommended that the Scottish Government should take forward a programme of work to scope out and design an efficient and cost effective tax system. This report aims to help inform that work.

1.9 Independence would provide a unique opportunity to design a modern and effective tax system which was not burdened by historical legacy or years of minor adjustments which, through time, serve to create complexity, cost and confusion.

1.10 The UK tax system has, for example, evolved over hundreds of years and is now full of allowances, credits, rates, conditions, reliefs and exemptions and complex processes for registration, administration, collection and payment.

1.11 Independence would also provide an opportunity to design a tax system that reflected Scotland’s size and circumstance.

1.12 This could be a major economic advantage for Scotland in the medium to long run. Studies show that the ease of paying taxes is a key driver of business activity (both domestically and internationally). Moreover, a simple and efficient tax system, coupled with supportive employment and benefit policies, can help the development of an effective labour market.

1.13 Unfortunately, much of the debate that characterises options for tax reform centres upon winners and losers of a particular tax change without considering the overall impact on a particular individual or household from the full package of reforms put forward or the wider benefit to the economy as a whole.

1.14 If a new tax system did have to be designed for Scotland as a result of independence, this would provide an opportunity to consider the full package and system wide proposals in a manner not possible in other situations. This would allow the complete package of reforms to be assessed against the economic and social objectives of the people of Scotland alongside an assessment of ‘winners’ and ‘losers’ from any reforms to be undertaken.

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Box 1.01 - Selected recommendations from the macroeconomic framework proposal

Fiscal framework:

The Scottish Government should look to establish a fiscal framework – including the use of fiscal rules and an independent fiscal commission – which maximises economic policy flexibility and provides opportunities to promote economic growth, deliver greater economic resilience and address inequalities in Scotland.

Recommendation: the framework should focus on long-term sustainability through effective management of the public finances alongside ensuring growth, economic policy flexibility and creating opportunities.

Recommendation: the Scottish Government should seek, in principle, to establish a stabilisation fund such as an Oil Fund, to help manage its natural resources and to enhance future economic resilience.

Economic levers:

Independence would provide a substantial step change in the economic and social policy levers open to future Scottish Governments. A clear, evidence based and robust debate should take place to discuss how best to meet key priorities.

Recommendation: the Scottish Government should take forward a programme of work to identify and develop key economic and fiscal policy opportunities and choices within the proposed framework to deliver economic growth, resilience, fairness, opportunity and sustainability.

Recommendation: as part of this work, lessons should be drawn from the successful use and application of economic levers from other economies of comparable size.

Recommendation: in particular, in addition to boosting economic growth, the Government should explore and prioritise opportunities to address inequalities and to promote intergenerational equity and environmental sustainability.

Recommendation: the Scottish Government should take forward a programme of work to scope out and design an efficient and cost effective tax system.
1 Introduction

**Tax and Policy Linkages**

1.15 These recommendations recognise the crucial role of fiscal policy, and taxation, in the design of any macroeconomic framework.

1.16 This paper provides an introductory foundation for this work by setting out the importance of fiscal policy and the role of taxation, the principles of a simple and effective tax system and the opportunities, responsibilities and choices that an independent Scotland would face.

1.17 The Working Group has been tasked with setting out the principles specifically regarding the design of the tax system. In practice, the Working Group fully recognise that the tax system cannot be considered in isolation and a system wide view approach is vital, particularly in terms of the linkages with the welfare system.

1.18 Touching on these important overlaps, this paper intends to highlight the areas where independence would provide the opportunity to create greater synergies and a comprehensive overall system of taxation and welfare – including the use of streamlined institutions and joint policy making and implementation.

1.19 Given the linkages between taxation and welfare, consideration should also be given to the report of the independent Expert Working Group on Welfare\(^4\) – which examined the costs, delivery and transition, and priorities for change in relation to welfare in the event of constitutional change.

1.20 The Working Group note the Expert Working Group on Welfare’s findings that there is a very strong appetite across Scotland for a wider conversation about the principles and policies, opportunities and choices, which future governments in an independent Scotland might wish to pursue – and would emphasise that welfare and taxation are considered alongside each other as far as possible.

1.21 There is a substantial evidence base on taxation and tax reform, including comprehensive reviews of the UK tax system and opportunities for reform – such as the Mirrlees Review\(^5\).

\(^4\) [http://www.scotland.gov.uk/Publications/2013/06/8875](http://www.scotland.gov.uk/Publications/2013/06/8875)

1.22 This paper does not aim to compete with, or replicate work of this scale, but rather to use this evidence base to present the principles of taxation and overall objectives which the Working Group believes should drive the creation of a modern and efficient tax system for an independent Scotland.

1.23 The Working Group trusts that setting out these principles can help facilitate and stimulate discussion on the best form of tax system for Scotland, both in the context of independence or even in the event of the transfer of more fiscal autonomy.

**Report structure and overview**

1.24 Chapter 2 sets out the current tax powers of the Scottish Government and Scottish Parliament, the new responsibilities under the Scotland Act 2012, and the additional powers which would flow from independence. Characteristics of the current UK tax system are also explored.

1.25 Chapter 3 discusses the fundamental rationale for taxation and the key principles of an effective tax system.

1.26 Chapter 4 examines international trends in taxation over the last 30 years. Different international 'models' of taxation are discussed to illustrate the rich variation in tax regimes that exist. What this evidence shows is that whilst economies face similar challenges and opportunities, they approach them in their own unique way. One common thread is that small countries tend not to be scaled-down versions of large economies, choosing instead to coordinate and pool resources to seek efficiencies and economies of scale that best suit their own circumstances. Streamlined institutions allow a more focused and aligned environment for the design and implementation of tax policy, and the chapter sets out these opportunities and possible trade-offs.

1.27 Chapter 5 presents a series of issues, opportunities and choices which the Working Group believe Scotland should consider when designing its own tax system. Scotland should aim to build a modern tax system fit for the 21st century – structured around the principles of simplicity, neutrality, stability and flexibility – whilst also focussing on improving long-run sustainable growth and tackling inequalities. Getting this right, and ensuring a smooth transition to a new system, will be challenging. However, it also represents a unique opportunity that could provide a major competitive advantage.
1 Introduction

1.28 Chapter 6 concludes and presents a set of recommendations for Scottish Ministers to consider.
Chapter Summary

- Chapter 2 provides a summary of taxation and fiscal policy in Scotland under the current constitutional settlement and the responsibilities and levers which Scotland would assume with independence.

- An independent Scotland would inherit the UK tax and benefit system on Day 1. This chapter outlines some of the key features of the current regime and opportunities for reform.

- The UK tax system performs broadly in line with other large and medium sized developed economies in terms of international rankings, however, there are concerns regarding its complexity, cost, the gap between actual revenues and those expected if all taxes were collected, uncertainty and lack of principles-based approach.

- In considering the strengths and weaknesses of taxation, it is essential to reflect upon the entire system and not just one element. For example, in considering the tax burden on business or on labour, the full range of taxes and links to other aspects of government policy, such as welfare and government investment, should also be considered.

- With full control of fiscal policy, Scotland would have the opportunity to design a comprehensive and cohesive system which addressed some of these challenges and focused on the key strengths and characteristics of the Scottish economy and society.

Background

2.1 Table 2.01 presents a summary of the key fiscal policy dimensions under the proposed macroeconomic framework put forward by the Working Group. It also contrasts these responsibilities with the ‘status-quó’, including the responsibilities to be devolved to Scotland in 2015 by the Scotland Act 2012.
### 2 Taxation in Scotland and the UK

#### Table 2.01 - Summary of Macroeconomic Framework Proposal – Fiscal Policy

<table>
<thead>
<tr>
<th>Principal Funding Source</th>
<th>STATUS QUO (incl. Scotland Act)</th>
<th>MACROECONOMIC FRAMEWORK</th>
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<tbody>
<tr>
<td></td>
<td>• Block Grant</td>
<td>• Full tax raising potential of Scotland</td>
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| Revenue Autonomy         | • 15% of tax revenues to be devolved by 2016 | • Full Autonomy (rates, bands, allowances and administration) |
|                          | • Restricted to 2 Devolved taxes (Land and Building Transaction Tax and a Scottish Landfill Tax) and 2 local taxes (council tax and business rates) | • 100% of revenues responsibility of Scottish Parliament. |
|                          | • Sharing of income tax revenues, although most key decisions on rates, allowances and tax bands retained by UK Government | |

| Expenditure Autonomy     | • Current devolved responsibilities (Health, Education etc) | • Full Autonomy to determine priorities |
|                          | • Scottish Parliament responsible for allocating around 60% of public spending | • Maximum opportunities to integrate and align key spending priorities with revenue autonomy |
|                          | | • 100% of expenditure (including welfare and defence) responsibility of Scottish Parliament |

| Fiscal Responsibility (including debt management) | • Fiscal envelope largely determined by UK Government | • Scottish Government fully responsible for fiscal sustainability |
|                                                  | • Limited feedback from policy choices to revenues - constrained incentives and accountability | • Overarching ‘fiscal sustainability agreement’ to prevent excess borrowing and debt within Sterling Zone |
|                                                  | • Modest capital borrowing from 2015 | • Arrangements for financing existing UK debt agreed as part of post-referendum negotiations |
|                                                  | • Possible role for independent fiscal commission | • Scottish Fiscal Commission to advise on sustainability of fiscal policy |

### Current Fiscal Framework

2.2 The Scottish Parliament currently has limited revenue raising capacity through taxation.

2.3 At present, the Scottish Government is responsible for 7% of total tax revenues raised in Scotland – via council tax and non-domestic rates.
2.4 Under the current arrangements, the majority of Scottish Government spending is financed by the Scottish Block Grant which is determined in the main by operation of the Barnett Formula. In effect, the vast majority of tax revenues raised in Scotland are set and collected at the UK level, before the UK Government reallocates a proportion back to Scotland via the Scottish Block Grant.

**Chart 2.01 - Scottish Tax Receipts (2011/12)**

![Bar chart showing Scottish Tax Receipts (2011/12)]

Source: Government Expenditure and Revenue Scotland 2011/12. Analysis assigns Scotland an illustrative geographical share of North Sea tax revenue

**Scotland Act 2012**

2.5 The Scotland Act 2012 will provide a limited increase to these tax powers – see Chart 2.01.

2.6 From April 2015, the Scottish Government will be responsible for a Land and Buildings Transaction Tax and a Scottish Landfill Tax.

2.7 The Scotland Act also gives the UK Government power to add to the Scottish Parliament’s legislative competence by devolving responsibility for further taxes, by Order, with the agreement of the Scottish and UK Parliaments.

2.8 A Scottish Rate of Income Tax (SRIT) will be introduced in April 2016. From this date the basic, higher and additional rates of income tax levied by the UK Government in Scotland on earned income will be reduced by 10 pence alongside a corresponding reduction in the block grant. The Scottish Government will then effectively have the opportunity to vary the basic, higher and
additional rates of income tax on earned income equally by up to 10 pence (downwards) and by an unconstrained amount upwards, and retain this revenue after the income tax accounts have been reconciled with earlier forecasts.

2.9 Key elements of the income tax system, such as the setting of personal allowances, or the opportunity to vary tax rates for particular groups, such as pensioners, and between the different bands of income tax, will however, remain reserved.

2.10 In reality, the new income tax powers provided under the Scotland Act will only transfer relatively limited autonomy from an economic perspective and are not a marked step change from the existing Scottish Variable Rate (SVR).

2.11 While the transfer of powers may be limited, the reforms do represent a significant administrative change to the UK tax system. HMRC will continue to operate and administer the collection of income tax, but they will be required to identify ‘Scottish taxpayers’ in order to apply the variable Scottish rate of income tax.

2.12 The requirement to identify Scottish taxpayers by 2016 illustrates that there will be administrative differences across the UK tax system irrespective of the outcome of the referendum.

2.13 It is interesting to note that the transfer of new powers has led to the Scottish Government proposing the implementation of a different framework for taxing land and building transactions to that which they have inherited. This appears to reflect differences in preference and application. The Land and Buildings Transaction Tax (Scotland) Act received Royal Assent in July 2013, having been passed by the Scottish Parliament in June 2013.

2.14 The new Scottish tax will move away from the ‘slab’ structure of UK stamp duty land tax, in which tax is levied against the entire purchase price at a fixed rate depending on the value of the property. The tax rate applied varies depending on the cost of the property (based on bands), but applies to the full value, creating a slab or step effect. In contrast, the Scottish Government will implement a progressive structure in which the marginal tax rate is charged on the value above

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6 The SVR provided the opportunity to vary the UK basic rate of tax by 3 pence up or down. Given that this power was never used, effectively increasing this range to 10 pence will, from an economic point of view, not provide a major change in autonomy. Moreover, a decision on whether to use the SVR was contained in each Budget thus arguably providing a similar degree of accountability.

7 http://www.scottish.parliament.uk/parliamentarybusiness/Bills/56718.aspx
certain thresholds, in an effort to reduce the apparent and widely reported distortive effects of the existing UK scheme.

2.15 In choosing to set up a new tax and collection system in Scotland, the approach to the land and buildings transaction tax has illustrated that, even in just one tax policy, a different view may be taken in Scotland relative to the rest of the UK.

2.16 Even accounting for the additional tax powers that the Scotland Act 2012 will devolve, the UK Government will still be responsible for approximately 85% of Scottish tax revenues. The Block Grant will remain the key funding source for the Scottish Government. How this is funded in the future – e.g. a continuation of Barnett or through a new mechanism such as a Needs Based Assessment exercise – is open to future UK Governments to decide.

2.17 Responsibility for key tax levers which can have a significant impact on Scotland’s long-term economic performance such as business taxation, personal taxation, R&D allowances and other credits, duties, and energy taxation will all remain reserved.

2.18 Similarly, the tax elements which can be used to shape environmental objectives (so called green taxes) or deliver social objectives (such as employment taxation or the progressivity of the overall tax structure) will also remain centralised.

2.19 Moreover, the responsibility of managing the design of the tax system as a whole, including the balance of taxes and the cohesion of the tax and welfare landscape, will also remain with the UK Government.

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8 With the exception of the devolved landfill tax.
Centralised taxation

2.20 Taxation in the UK is highly centralised when compared to other countries.

2.21 Chart 2.02 illustrates the proportion of taxes raised at different levels of government across a selection of OECD member countries.

2.22 Across the OECD, the average proportion of tax revenues collected at the state or local government level is approximately 24%. Canada shows the most devolution in tax raising powers, with a near 50:50 split between federal government/social security and state/local government.

Chart 2.02 – Tax revenues by level of government, 2010 (%)

Source: OECD Statistics

2.23 The UK is relatively atypical in that such limited revenue autonomy is coupled alongside a high degree of expenditure autonomy (both in terms of the scale of such spending responsibilities but also the flexibility to set specific priorities).

2.24 This has a number of potential hypothetical benefits around the relative size and predictability of revenues (though this does depend to a large extent on how any grant-based system operates in practice), however, such an imbalance has the potential to bring challenges for accountability and incentivising good governance and promoting efficiencies.
2.25 In theory, greater revenue raising responsibility for a given level of expenditure autonomy can improve accountability and transparency by providing a stronger and more visible link between expenditure and tax choices.

2.26 At the same time, budgets determined by a central government are not directly linked to growth and employment needs of a regional economy, or the preferences of regional/local populations or their willingness to pay for the provision of services. This may lead to inefficiencies in the decision-making process.

2.27 Economic theory would suggest that centralisation of revenue raising responsibility can also constrain incentives for good policy making at the local level. It can be argued that the creation of a ‘hard’ budget constraint can drive the efficient delivery of public services by making policy makers responsible for balancing the benefits and costs of their spending decisions. In contrast, with sub-central tax responsibility the benefits realised from effective local policies – such as lowered costs or increased tax revenues - remain at the local level, rewarding and incentivising good policy making (and punishing poor policies).

2.28 In an independent Scotland, the degree to which tax (and expenditure) powers were operated at a sub-national level would be a decision for the Scottish Government and Scottish Parliament.

Independence: Macroeconomic Framework Proposal

2.29 As set out in the Working Group’s first report, the potential power and extent of new policy autonomy that would flow to Scotland under independence should not be underestimated. This is particularly true from just one element of the overall macroeconomic framework – taxation.

2.30 With independence, Scotland would assume full responsibility for revenue raising and taxation policy.

2.31 Independence would present the Scottish Government and Scottish Parliament with the powers to determine what taxes to implement, at what rates and the structure of these taxes in terms of the bandings, allowances and reliefs.
2 Taxation in Scotland and the UK

2.32 Responsibility for tax collection and administration would similarly be fully the domain of the Scottish authorities.

2.33 The expectation is that the principle of continuity of law would provide for the taxes and obligations currently reserved to the UK Government and levied in Scotland, automatically transferring to the Scottish Government unless the Scottish Parliament made provisions for changes to come into effect immediately upon independence.

2.34 It is likely that the process of transition to tax independence will take place over a number of years. There will therefore likely be merit – as set out in one of our recommendations in Chapter 6 – for a rolling process of reform as the new system is developed and established. This would be similar to the process of implementing the Scotland Act 2012.

2.35 Short of full fiscal autonomy in an independent Scotland, a number of alternatives have been advocated. These include:\9

- “devolution max” – full fiscal autonomy within the UK;
- enhanced devolution;
- assigning revenues to the Scottish Parliament; and
- continuing with or marginally changing the current framework.

2.36 The Scottish Government has assessed the potential options against the criteria of enhanced efficiency, greater transparency and accountability, and sustainability\10. The Scottish Government concluded in their view that full fiscal autonomy in an independent Scotland would deliver the framework to support increased long-term sustainable economic growth.

2.37 The Scottish Parliament also established the Commission on Scottish Devolution (Calman Commission)\11 to review the constitutional settlement in light of experiences and recommended changes. The Commission, whose remit excluded independence or full fiscal autonomy, recognised the success of the devolution of powers and called for greater devolution of many tax levers

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9 Definition and discussion of these options can be found in the Scottish Government publication Fiscal Autonomy in Scotland (2009), [http://www.scotland.gov.uk/Publications/2009/02/23092643/0](http://www.scotland.gov.uk/Publications/2009/02/23092643/0)


including income tax and Air Passenger Duty. This work underpinned the subsequent Scotland Act 2012, though some of its recommendations, such as the devolution of Air Passenger Duty, have not yet been acted upon.

2.38 Further devolution is likely to provide opportunities to vary UK tax policy at the margin, whilst maintaining a relatively unified system across the UK.

2.39 However, from a purely tax-reform perspective, in the absence of a system wide approach, the ability of reforming devolved taxes more fundamentally – irrespective of the merits or otherwise of doing so – would be constrained.

2.40 Under independence, the Scottish Government and Parliament would be able to decide the extent to which the current UK system was adequate for an independent Scotland, and therefore the degree of reform required. This could range from small alterations to a more significant overhaul.

2.41 As such, independence provides an opportunity to undertake a more fundamental assessment of the entire tax system (i.e. in choosing the tax base, thresholds, exemptions, rates, and hedging revenues across a number of streams) over and above the opportunity presented by further devolution to vary taxes at the margin only.
2 Taxation in Scotland and the UK

Taxation in the UK

2.42 Table 2.02 illustrates the range and level of the main taxes raised in both Scotland and the UK as a whole.

2.43 Unlike some other countries, tax revenue statistics at a sub-central level are not currently produced in the UK.

2.44 To fill this gap, the National Statistics publication ‘Government Expenditure and Revenue Scotland’ (GERS) provides estimates of Scottish tax receipts based upon UK outturn data and estimated shares for Scotland. In certain instances, actual outturn data for Scotland does exist, and in these cases it is used instead.

2.45 As the table illustrates, income tax, national insurance contributions and VAT make up the largest share of both Scottish and UK revenues.

2.46 North Sea taxation is also highlighted in the table. Consistent with the conventions applied in GERS, three figures for total current revenue are provided – excluding North Sea Revenues, assigning a per capita share of North Sea Revenues to Scotland, and assigning an illustrative geographical share of North Sea Revenues to Scotland.
2.47 Excluding North Sea oil and gas receipts, the overall balance of taxes is estimated to be broadly similar between Scotland and the UK. This is unsurprising, given that most taxes are reserved to the UK Government and the Scottish economy shares many similar characteristics to that of the UK\textsuperscript{12}.

\textsuperscript{12} See Chapter 4 of the FCWG first report.
2.48 Chart 2.03 illustrates the commonality between Scotland and the UK in terms of the
collection of different tax categories to total revenues. The one main area of difference is with
regard to the relative contribution of North Sea taxation. Excluding North Sea revenues, current
revenues are broadly in line with one another across Scotland and the UK on a per capita basis, with
Scottish per capita revenues 98 per cent of those in the UK in 2011-12. Including a geographical
share of North Sea, this rises to 119 per cent.

Chart 2.03 – Composition of Scottish and UK tax receipts – onshore and offshore (2011-12)

Source: Government Expenditure and Revenue Scotland 2011-12,
http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/GERS

2.49 However, such high level charts hide a degree of variation between Scotland and the UK,
particularly with regard to individual taxes.

2.50 For example, income tax makes up a higher share of tax receipts in the UK relative to
Scotland. Table 2.03 below illustrates the contribution of tax share across the income distribution.
Table 2.03 - Share of Income Total Tax by Percentile Groups, 2010-11

<table>
<thead>
<tr>
<th>Percentile Groups (ranged on total income before tax)</th>
<th>Bottom</th>
<th>1%</th>
<th>5%</th>
<th>10%</th>
<th>25%</th>
<th>50%</th>
<th>25%</th>
<th>10%</th>
<th>5%</th>
<th>1%</th>
<th>Total Income tax (All taxpayers)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010-11 (UK)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>£154 bn</td>
</tr>
<tr>
<td>2010-11 (Scotland)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>£11.1 bn</td>
</tr>
</tbody>
</table>

Source: HMRC – Income Tax Liabilities Statistics (Table 2.4) and Scottish Government analysis based on the HMRC Survey of Personal Income Public Use Tape

2.51 National insurance contributions are less progressive than income tax, and correspondingly the share of tax receipts from NICs are similar in Scotland and the UK (excluding North Sea revenues), in spite of the relatively higher prevalence of the highest income earners in the UK.

2.52 In addition to tax powers being highly centralised and set in the UK context, the welfare system is currently operated on a uniform basis across the UK – both in terms of eligibility and type of benefits.

Opportunities for reforming the current UK system

2.53 Despite the current UK system being highly complex it has a number of positive aspects.

2.54 The schedule for personal income tax is relative simple – although there is a lack of alignment with rates on income from savings and dividends and National Insurance contributions. In the main, income tax is withheld at source using Pay-As-You-Earn (PAYE) which is efficient. It also scores relatively well against other large competitor countries in a selection of measures (see for instance, Box 2.01 and Table 2.04).

2.55 Administration costs have fallen significantly over the past 3 years, while revenue collection has remained relatively stable. However, the degree to which the quality and level of service has been affected by cost cutting is uncertain – a lack of significant reform to the overall complexity of the system would suggest that efficiencies may be being driven by changes other than tax reform.

2.56 Instruments are available to encourage savings – such as Individual Saving Accounts (ISA) and tax free owner-occupied housing, although the different treatment of savings products can distort decisions about how to save. Increasingly, environmental concerns are being addressed with
2 Taxation in Scotland and the UK

a selection of green taxes on polluting activities, although there does not appear to be a consistent rationale articulated for their application.

2.57 The UK tax and benefit system as a whole has the potential to redistribute significant sums of income from the most well off to the least well off. Successive UK Governments have attempted to use this to varying degrees.

2.58 Many of the developments in the UK system over the past 30 years have been in line with other large developed economies, including increases in the share of revenue provided by VAT rather than taxes on specific goods and services, cuts in the basic and higher rates of income tax and the number of bands, falls in headline corporation tax rates alongside base broadening through reducing allowances, and a movement towards taxing individuals rather than households.\textsuperscript{13}

2.59 However, it is subject to a number of criticisms including –

- Complexity
- Cost
- Predictability
- The size of the tax gap
- Complex institutional framework
- The lack of a clear principles-based approach

2.60 The Institute for Fiscal Studies has stated that there is “a fair amount of science suggesting that we could run our tax system better. The policy could be made to operate better. We could, for example, collect as much tax as we do and be as redistributive as we are currently but do it in a more efficient way if we chose to. There are opportunities there as well.”\textsuperscript{14}

2.61 An independent Scotland would have the opportunity to seek such improvements.


\textsuperscript{14} Scottish Affairs Committee, 12 June 2013, http://www.publications.parliament.uk/pa/cm201314/cmselect/cmscotaf/uc140-iv/uc14001.htm
Complexity

2.62 The current UK tax system has evolved over hundreds of years, and is now characterised by a complex landscape of exemptions, deductions and allowances.

2.63 It is estimated that there are over 10,000 pages of tax legislation, making it one of the longest in the world\(^\text{15}\).

2.64 The system has been altered around the edges over time in an attempt to adapt to evolving economic and social circumstances and technological advances. However, this has had consequences in terms of complexity. Indeed, reports argue that UK tax legislation is estimated to have doubled in length since 1997 alone.

2.65 The relatively recently established Office of Tax Simplification (OTS) found in 2010 that there were 1,042 separate exemptions in the UK tax system\(^\text{16}\). Out of these 1,042 exemptions, an initial report by OTS examined 155, leaving 883 still to be looked at in detail\(^\text{17}\).

2.66 Margaret Hodge MP – chair of the UK Committee of Public Accounts – has stated that “Tax law is now hopelessly complex and outdated.”\(^\text{18}\) The Committee’s recent high profile inquiry into corporate tax payments concluded that: “HM Revenue & Customs (HMRC) is hampered by the complexity of existing laws, which leave so much scope for aggressive exploitation of loopholes, but it has not been sufficiently challenging of the manifestly artificial tax arrangements of multinationals”\(^\text{19}\).

2.67 Independence, by requiring Scotland to consider its own taxation system, would create an opportunity to establish a less complex system. It would require political willingness and imply tough choices. Reforms should be examined via an analytical framework which considers the costs and benefits of tax policies and allows for regular reviews to ensure they are meeting their objectives.

\(^{16}\)https://www.gov.uk/government/organisations/office-of-tax-simplification
\(^{17}\)http://www.hm-treasury.gov.uk/d/ots_review_tax_reliefs_final_report.pdf
\(^{19}\)http://www.publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf
Although a balance would need to be struck, a simpler and more efficient tax system must be a clear goal. In view of the tax reforms undertaken elsewhere, a more effective tax should be considered an achievable ambition.
Box 2.01 - Ease of doing business

Tax administration is an often overlooked determinant of a country’s competitiveness. It can however have a significant economic impact.

The wider regulatory environment and strength of institutions – including business registration and reporting, planning permission, access to credit, intellectual property rights, contract enforcement and overall continuity – all factor into the overall ‘ease’ of undertaking business.

Policies to improve economic competitiveness and growth, both in terms of facilitating domestic business expansion and investment, and in attracting inward investment, should focus on the regulatory and industrial environment as a whole, including, but not limited to, taxation policies.

The World Bank and the International Finance Corporation jointly publish an annual report ranking 185 world economies according to their ease of doing business on the basis of ten measures that impact on everyday business activity.20

In 2012, the ‘Doing Business’ project ranked the United Kingdom as the seventh best country in terms of the ease of doing business based on the ten measures of regulation and laws.21 Of the six countries ranked above the United Kingdom, five are small open economies with populations of less than seven million.22

In terms of the tax element - both the rates of tax and measures of the administrative burden of taxes (number of payments and time taken) - the UK ranks 16th, behind countries such as Denmark, Ireland and Singapore.23

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20 http://www.doingbusiness.org/
21 Such international rankings are useful indicators, however they should not be considered in isolation. International indexes capture a variety of effects, and comparability is often unclear. This highlights the value in considering a range of factors and the need to evaluate findings in their wider context. Importantly in the context of taxation, governments should focus on removing ‘unnecessary’ burdens, regardless of their relative ranking internationally.
22 Top 10 rankings in order: Singapore, Hong Kong, New Zealand, United States, Denmark, Norway, United Kingdom, Rep of Korea, Georgia, Australia
Alongside reducing complexity, independence would provide Scotland with the opportunity to move towards a less administratively costly and more efficient tax system. This would be of benefit to both the public sector and private sector.

The degree to which the Scottish and UK systems operated entirely independently of one another would depend on the mutual benefits and efficiency savings for both countries in cooperating across certain areas.

Indeed, there may be some areas where a coordinated approach could still be taken forward, particularly in any transition period and to avoid the exploitation of transfer pricing. In such situations, pooling administrative resources may be advantageous to both Scotland and the UK. For example, the sharing of tax information on businesses operating in both countries to ensure appropriate taxes are collected on both sides of the border.

Subsequent chapters demonstrate such approaches are possible, and many small open economies and regional economies in larger jurisdictions have successfully done so, without risking tax avoidance – through both profit shifting or taking advantage of transfer pricing rules – or a ‘race to the bottom’.

The UK system has improved in recent years and performs relatively well – in terms of costs of collection – with other comparable sized countries. However, there continue to be well publicised examples of inefficiencies and avoidable costs (See Chart 2.04 for instance).

In establishing a new system, the Working Group would encourage the Scottish Government to look at the good (and bad) experiences of other countries.

Ireland, for example, has been identified as a country where paying business taxes is relatively simple. Both the average number of payments required, and the total compliance time are lower than in the UK. Along with competitive business taxes, it is generally seen to enhance its competitiveness and attractiveness as a place for conducting business.

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24 ibid
2.76 The most recent data shows that administration costs in the UK, measured as a proportion of net revenues collected, while in the mid-point of international rankings, are higher than in many countries. Table 2.04 highlights that taking the average over the previous 3 years of data, UK tax administration costs were mid-ranked internationally. Over the three years, UK administration costs were higher than in many countries of a comparable scale to Scotland, including Denmark, Sweden and Finland\(^25\).

2.77 Administrations costs, measured in this manner, are more than 50 per cent lower in Sweden or Switzerland than in the UK.

### Table 2.04 - Cost of collection ratios (administrative costs/net revenue) 2009-11 average

<table>
<thead>
<tr>
<th>Country</th>
<th>Administrative Costs</th>
<th>Net Revenue</th>
<th>Average Cost of Collection Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>0.36</td>
<td></td>
<td>1.03</td>
</tr>
<tr>
<td>Sweden</td>
<td>0.40</td>
<td></td>
<td>1.16</td>
</tr>
<tr>
<td>Switzerland</td>
<td>0.40</td>
<td></td>
<td>1.17</td>
</tr>
<tr>
<td>Iceland</td>
<td>0.41</td>
<td></td>
<td>1.25</td>
</tr>
<tr>
<td>United States</td>
<td>0.63</td>
<td></td>
<td>1.33</td>
</tr>
<tr>
<td>Mexico</td>
<td>0.66</td>
<td></td>
<td>1.35</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.71</td>
<td></td>
<td>1.36</td>
</tr>
<tr>
<td>Austria</td>
<td>0.74</td>
<td></td>
<td>1.45</td>
</tr>
<tr>
<td>Chile</td>
<td>0.79</td>
<td></td>
<td>1.80</td>
</tr>
<tr>
<td>Korea</td>
<td>0.80</td>
<td></td>
<td>2.50</td>
</tr>
</tbody>
</table>

Source: OECD, Tax Administration 2013, Comparative information on OECD and other advance and emerging economies

2.78 Changes in the tax burden and fluctuations in tax revenue can have a significant impact on the cost of collection ratios, this was demonstrated in Ireland where the cost of collection ratio increased from 0.78 in 2006 to 1.26 in 2010. Costs as a percentage of GDP can also be used as a helpful indicative performance benchmark as this removes the impact of changes in tax revenue, although the ratio can still be affected by temporary cost increases resulting from one-off investments or the introduction of a new tax.

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\(^{25}\) In the last year which data is available, which is more exposed to fluctuations in tax revenues and GDP, costs per revenue are 0.83 in the UK, 0.71 in Denmark, 0.40 in Sweden, and 0.80 in Finland.
2 Taxation in Scotland and the UK

2.79 While costs for tax administration in the UK, measured as a percentage of GDP, compare broadly to other large and medium sized developed countries, on average over the last three years many have exhibited significantly lower ratios of tax administration costs to GDP than the UK – including countries of comparable scale to Scotland. For instance, according to OECD data\textsuperscript{26}, tax administration costs as a percentage of GDP averaged over the last three years were:

- 0.29% for Germany;
- 0.27% for the UK;
- 0.26% for Ireland;
- 0.24% for Denmark; and,
- 0.18% for the Sweden.

2.80 While the UK does well relative to its medium-large sized competitors, many smaller countries appear to make a virtue of focusing on becoming an efficient cost administration tax jurisdiction\textsuperscript{27}. However, it should be noted that this does not necessarily mean low tax rates.

2.81 Scottish taxpayers currently contribute to the administration of institutions such as HMRC\textsuperscript{28}.

2.82 Administration costs ultimately depend on the efficiency of the tax collection authorities and the complexity of the tax system. In principle, Scotland could make a concerted effort to deploy modern technologies – such as online filing and pre-filled tax assessments – alongside a system designed around simplicity and transparency to minimise administrative costs while ensuring the system did not put an undue burden on individuals and businesses.

2.83 As shown above, there are alternative methods to benchmark tax administration costs – including using costs as a percentage of tax revenue and as a percentage of GDP.

2.84 The experience of comparable countries such as New Zealand and Ireland is likely to be relevant in assessing future costs. If Scotland was able to improve the efficiency of tax collection and

\textsuperscript{26} OECD, Tax Administration 2013, Comparative information on OECD and other advance and emerging economies (average taken over last 3 years of data – 2009-11)

\textsuperscript{27} In the last year which data is available, which is more exposed to fluctuations in tax revenues and GDP, costs per GDP are 0.24% in the UK, 0.25% in Ireland, 0.20% in Denmark, 0.17% in Sweden.

\textsuperscript{28} Based on the £3.84bn HMRC spent in 2011-12, Scotland’s population share of costs would be £323m.
reduce the cost ratios of tax administration to levels seen in Sweden, New Zealand and other small countries, this would represent a significant cost saving.

2.85 Taking Denmark for instance, if Scotland was able to bring administrations costs ratios to similar levels as seen there over the last 3 years, costs may be expected to have been in the range of between £298m and £335m in 2011-12. Whereas if Scotland had administration cost ratios which corresponded to the UK, indicative costs would be in the range of £336m to £430m.

2.86 Such figures are of course illustrative, as administration costs are dependent on a number of factors including the complexity of the tax system as outlined above, but they demonstrate the potential for efficiencies if Scotland was successful in creating a low cost administration.

2.87 An independent Scotland would be responsible for administering all taxes, and would incur one-off costs in setting up a tax administration system in Scotland. These costs would be dependent on the systems adopted and on negotiations of assets and liabilities with the UK Government – part of which would involve transition processes. Presently HMRC has over 8,000 employees based across Scotland, this experience in tax administration is something which an independent Scotland could utilise.

2.88 The Scottish Government is currently in the process of setting up a tax authority in Scotland, Revenue Scotland, which will be responsible for administering the Land and Buildings Transaction Tax and the replacement for the UK Landfill Tax from 2015. This experience of setting up a system of tax administration would provide a further helpful foundation for the formation of a tax administration system for all taxes in Scotland.

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29 Calculation uses 2011/12 estimate of Scottish GDP with per capita share of North Sea oil from GERS. A per capita share of oil is used as administration costs of offshore taxation would be expected to be relatively unaffected by the level of oil production – making the estimate more comparable to the UK figure. Estimates of tax revenue exclude non-domestic rates, council tax, interest and dividends, gross operating surplus and rent and other current transfers.

Predictability

2.89 Another area that impacts upon cost is predictability and transparency. All else remaining equal, a more stable system will be less costly than a more unstable one. Predictability and transparency are central to this.

2.90 In designing new tax policies, governments routinely consult with business and interested stakeholders through a mixture of formal written consultations and wider engagement – both formal and informal – at the various stages of policy development.

2.91 However, insufficient time is often given for such scrutiny, with governments often keen on ensuring the protection or generation of extra revenues from particular measures. As a result the consequences of particular changes are often not fully understood as policies are implemented in response to short-term pressures (both political and practical).

2.92 Unintended consequences from poorly understood policies run the risk of defeating the original purpose of the policy change, and can impose long term damage if they result in the perception of a lack of predictability in the tax regime.

2.93 Predictability is especially important for ventures with long term return horizons. In Scotland, one such area is oil and gas. However, this one area has actually been subject to a high degree of change.
Box 2.02 - UK oil and gas fiscal regime

Over the past decade the UK Government has made 16 changes to the oil and gas fiscal regime. These changes have included the introduction and subsequent increases in the supplementary charge and restrictions on decommissioning relief.

Recent analysis by the Institute for Fiscal Studies on the North Sea fiscal regime concluded that it “creates additional uncertainty by changing too frequently.”

Recent evidence from the Oil and Gas UK 2013 Activity Survey has highlighted the impact that such uncertainty can have on an industry. The industry body has stated that “the lack of new fields coming on-stream can be attributed to the damage done to investors’ confidence by the numerous adverse tax changes in the early and mid-2000s.”

The Scottish Government recently published its own vision for the oil and gas fiscal regime in an independent Scotland setting out a commitment to long-term stability and certainty in the fiscal and regulatory regimes.

The Size of the Tax-gap

2.94 Estimates of tax gaps have been developed in the UK and internationally to estimate the difference between taxes due and taxes collected. HMRC define the tax gap as an estimate of the “tax that is lost through non-payment, use of avoidance schemes, interpretation of tax effect of complex transactions, error, failure to take reasonable care, evasion, the hidden economy and organised criminal attack.”

2.95 Estimates of tax avoidance are particularly contentious and challenging to measure as they rely on the subjective interpretation of the ‘spirit of the law’ – i.e. the intention when setting the law.

31 http://www.oilandgasuk.co.uk/templates/asset-relay.cfm?frmAssetFileID=1296
32 Institute for Fiscal Studies – Green Budget 2013, Page 281
33 http://www.oilandgasuk.co.uk/cmsfiles/modules/publications/pdfs/EC037.pdf
34 http://www.scotland.gov.uk/Publications/2013/07/5746
2 Taxation in Scotland and the UK

2.96 In the UK, the tax gap is estimated to have been around £35 billion, or 7 per cent of the total due in 2011-12\textsuperscript{36}. 11 per cent of this, £4 billion, is reported to arise through tax avoidance schemes.

Chart 2.04 – UK tax gap by behaviour (2011-12)

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Error</td>
<td>£2.9 billion</td>
<td>8%</td>
</tr>
<tr>
<td>Criminal attacks</td>
<td>£4.7 billion</td>
<td>12%</td>
</tr>
<tr>
<td>Evasion</td>
<td>£5.1 billion</td>
<td>16%</td>
</tr>
<tr>
<td>Hidden economy</td>
<td>£5.4 billion</td>
<td>16%</td>
</tr>
<tr>
<td>Avoidance</td>
<td>£4.0 billion</td>
<td>12%</td>
</tr>
<tr>
<td>Legal interpretation</td>
<td>£4.3 billion</td>
<td>12%</td>
</tr>
<tr>
<td>Non-payment</td>
<td>£4.4 billion</td>
<td>13%</td>
</tr>
<tr>
<td>Failure to take reasonable care</td>
<td>£4.3 billion</td>
<td>11%</td>
</tr>
</tbody>
</table>

Source: HMRC Measuring Tax Gap

2.97 To give an idea of the scale of the tax gap, HMRC estimate that reducing the basic, higher and additional rates of income tax by 1p would result in the loss of £4.5 billion to the UK Exchequer in 2013-14\textsuperscript{37} – only 13% of the total tax gap in 2011-12. Similarly, all personal allowances could be increased by 10%, costing the exchequer £5.5bn compared to the £35 billion tax gap.

Complex institutional framework

2.98 The policy and delivery framework of tax system differs from country to country. In the UK, there are a variety of institutions operating in the tax and welfare domain in a mixture of policy design, delivery and oversight.

\textsuperscript{36} ibid

\textsuperscript{37} http://www.hmrc.gov.uk/statistics/expenditures/table1-6.pdf
2.99 For example in the context of personal taxation, the framework in the UK sees HM Treasury make policy decisions, while HM Revenue and Customs and the Department for Work and Pensions enact policy, overseen by the Office for Budget Responsibility and UK Parliament. Local authorities also administer Council Tax and the Council Tax Reduction scheme (replacement of Council Tax Benefit). Other bodies such as the Institute for Fiscal Studies offer independent analysis which in reality also play an important role.

**Figure 2.01 – UK tax and welfare institutional framework**

2.100 Such fragmented institutional frameworks have to be designed carefully so as to avoid any disconnect between policy makers and practitioners. In reality, such a system has greater potential to result in unaligned policy and delivery compared to a more consolidated model. Operational costs for instance, which may not always be fully considered in decision making, can be significant. Different areas will invariably have different focuses which may result in a disjoint in practices. For instance, policy makers may focus on the economic and revenue impacts, while being less concerned with the compliance costs for taxpayers.

2.101 New Zealand provides an example of integrated and aligned institutions. While having two bodies predominantly responsible for taxation – the Treasury and Revenue – they are closely aligned, and the Revenue Department has a significant role to play in tax policy, rather than just delivery of policy (and vice versa).

2.102 The anecdotal evidence suggests that countries of Scotland’s scale can – or choose to – build more streamlined institutions, with policy and delivery aligned across a small number of
institutions. Streamlining the institutions which operate and set tax and welfare policy has the potential to provide significant benefits in terms of ensuring a comprehensive and aligned whole system approach. There is no guarantee that this would happen under independence, but there would be clear scope to consider it.

The lack of a clear principles-based approach

2.103 As will be set out in the next chapter, a successful tax system should follow a clear and principled approach in its design and structure.

2.104 This itself provides certainty, stability and transparency. It is also helpful for informing investment and other economic decision making as it sets out a clear vision, not just for current policy, but also for the future strategy of an economy. It can also guard against costly distortions becoming embedded which while individually may appear attractive, when taken together, only serve to lead to complexities and inefficiencies.

2.105 While there have been a number of reforms in recent years to move the UK system toward a more principled based approach, it is still a far from a consistent system. This impacts not just on the tax system, but also on its relationship with other aspects of public policy, such as the welfare system.

2.106 Income tax and national insurance represent a good example of this complexity.

2.107 For example, under the current system, employed and self-employed individuals who undertake similar work are treated differently in terms of national insurance contributions. More generally, income tax and national insurance contributions, which are effectively two separate taxes on the same income stream, are measured on a different basis, with variations in rates, time periods, thresholds and applicability (National Insurance Contributions are paid per-job, rather than per individual, and are not paid by individuals over the State Pension Age).

2.108 Such a system erodes transparency and makes the system and tax liabilities difficult to understand.

2.109 Moreover, the contribution element of national insurance has reduced over time, and will do so further with the introduction of the single-tier state pension and the closing of the second
state pension in April 2016. The IFS have stated that “in practice, however, contributions paid and benefits received, bear little relation to each other for any individual contributor, and the link has weakened over time”\(^{38}\).

2.110 As such, there is substantial scope for streamlining the taxation of personal income. For instance, the government could potentially align the eligibility and thresholds of national insurance with income tax to improve clarity and transparency.

2.111 It is not just personal taxation where there appears to be a lack of coherence. Inconsistencies emerge in other taxes such as VAT and excise duties. In the current UK system, similar goods are treated differently for tax purposes for no apparent logical reason. For example, duty on cider, is around half the rate of beer duty in the UK\(^{39}\). To compound the complexity in the system the duties charged are based on different measures – with beer duty levied on the amount of alcohol in the product, while cider duty is charged on the unit of cider itself, although with different bandings for the strength of the cider.

2.112 With regard to links to the wider welfare system, the current system comprises a range of tax credits and benefits, with a mixture of means tested and universal provision. All of these can impact on the effective rate of taxation, especially at the margin, leading to often conflicting incentives with regard to certain activities such as participation in the labour market.


\(^{39}\) http://www.hmrc.gov.uk/rates/alcohol-duty.htm
The provision and withdrawal of different types of benefits and tax credits interacting with income tax and National Insurance payments result in complexities and variations in the tax rate across the range of the labour supply. In the example below an individual with: two children and one parent in work earning £9.50 per hour\textsuperscript{40}, face a complex tax structure. The chart shows how the household’s effective tax rate changes as the number of hours worked increase.

- Initially the household faces an effective marginal tax rate of 100 per cent due to the withdrawal of Jobseeker’s Allowance as household income increases.
- From 15 hours Housing Benefit and Council Tax Benefit begin to be tapered.
- From 16 hours the household receives Working Tax Credit which increases the overall income but the individual in work also starts paying National Insurance.
- Once the individual works 20 hours per week they start paying income tax, the payment of income tax and National Insurance contributions alongside the tapering of Tax Credits and Housing Benefit results in an effective marginal tax rate of 91 per cent.

Such examples highlight the links between the tax and welfare system, and the need for both to be considered alongside one another in design and operation.

\textbf{Chart 2.05 – Effective Marginal Tax Rate, 2013-14}

\begin{center}
\includegraphics[width=\textwidth]{chart.png}
\end{center}

Source: Scottish Government modelling

\textsuperscript{40} Modelling based on an individual with two children aged 5-10 living in the Social Rented Sector with weekly housing costs of £100, and one parent earning £9.50 per hour.
2.113 A number of studies, such as the Mirrlees Review\textsuperscript{41}, have suggested a range of possible opportunities for improvements in the UK tax system, and in particular, the move toward a more principles-based framework – see Box 2.04 for some suggestions from this work.

2.114 While it is up to policy makers to ultimately decide on the merits of a particular policy, including balancing out competing social and economic objectives, a key conclusion of this work was the need for greater consistency and adoption of clearly defined principles across the board. Departures from these principles could then be clearly set out, communicated and the reasons understood.

\footnotesize\textsuperscript{41} http://www.ifs.org.uk/mirrleesReview
Box 2.04 - Mirrlees Review – Commentary on the UK Tax System

The Mirrlees Review (http://www.ifs.org.uk/mirrleesReview) was a major study of the UK tax system undertaken by the Institute for Fiscal Studies in 2010/11. Independent expertise from over 50 international specialists and researchers helped set out the principles of an effective tax system, and reviewed the degree to which the UK system met these objectives. At nearly 2,000 pages, it remains the most comprehensive review of the UK tax system to date. It contained a number of comments and discussion, including 7 weaknesses in the UK tax system of the day –

- “Despite improvements for some groups in recent years, the current system of income taxes and welfare benefits creates serious disincentives to work for many with relatively low potential earning power. The benefit system in particular is far too complex.”
- “Many unnecessary complexities and inconsistencies are created by the fact that the various parts of the tax system are poorly joined up. These range from a lack of integration between income taxes and National Insurance contributions (NICs) to a lack of coherence between personal and corporate taxes.”
- “The present treatment of savings and wealth transfers is inconsistent and inequitable. There is no consistent tax base identified, saving is discouraged, and different forms of saving are taxed differently.”
- “We remain some way short of having a coherent system of environmental taxes to address imperatives around climate change and congestion. The effective tax on carbon varies dramatically according to its source, and fuel duty is a poor substitute for road pricing.”
- “The current system of corporate taxes discourages business investment and favours debt finance over equity finance. Its lack of integration with other parts of the tax system also leads to distortions over choice of legal form. Corporate taxes have also been subject to increasing international pressures.”
- “Taxation of land and property is inefficient and inequitable. There is a tax on business property—a produced input—but not on land, which is a source of rents. Taxation of housing involves both a transactions tax and a tax based on 20-year-old valuations.”
- “Distributional goals are pursued in inefficient and inconsistent ways. For example, zero and reduced rates of VAT help people with particular tastes rather than being targeted at those with low overall resources; and council tax is regressive for no obvious efficiency-improving reasons.”

2.115 As highlighted in the introduction, in looking at reviews such as the Mirrlees Review and the experiences of other countries, it is important not to pick individual elements to argue in favour or against the merits or demerits of a particular action. Such an approach would be partial, misleading and flawed. Any framework which looks across the entire system, by definition, needs to examine
the totality of the proposition and the overall political, economic and social objectives trying to be achieved.

2.116 This is important in the Scottish context, where in designing a new tax framework, the entire system should be considered.

Summary

2.117 Scotland would inherit a tax system which has a number of positives aspects, but also significant room for improvement – especially in the context of a country of Scotland’s scale, with its unique strengths and challenges, and also its place in the modern global economy.

2.118 The UK tax system is highly complex.

2.119 Scotland would have the opportunity to design a tax system which was fully integrated with its wider fiscal policy and objectives on economic growth, equality and sustainability. Alignment of the tax and welfare systems – in effect opposite sides of the same overall system – would be a critical starting point. Crucially, independence would provide the opportunity to design the system with a clear and principles based approach.
2 Taxation in Scotland and the UK
3. Principles of Taxation

Chapter Summary

- This chapter provides a summary of the role of taxation, key principles which should be used in its design, and the different methods of taxation available.

- Fundamentally, taxation plays a number of important roles in a modern economy. It –
  - funds expenditure on public services and other obligations (e.g. debt);
  - can be used to help meet equity preferences (e.g. by redistributing resources);
  - can influence behaviour, such as to help deliver environmental objectives;
  - plays an important role in helping to smooth macroeconomic fluctuations as part of a wider fiscal and macroeconomic framework; and,
  - supports growth, employment and a diversified industrial base.

- To meet these objectives in the most effective manner a tax system should focus on sound principles.

- For a given set of objectives, a tax system which is simple, neutral and stable is desirable. A well designed tax system also strikes an appropriate balance between stability and flexibility. This also allows the government to adapt to changing economic and social circumstances while still creating a system which encourages predictability and certainty.

- Getting a tax system correct is important - increasingly so in the context of the global economy. A weak tax system can lead to loss of revenue and dissuade investment and growth.

- Income taxes, wealth taxes, and expenditure taxes are the broad categories used in the design of a tax system.

- There are trade-offs between the simplicity of the tax system, and the scope to micro-manage individual tax elements in an effort to meet specific government objectives.

- Every government approaches this in their own unique way and in a manner which reflects their political, economic and social objectives.

- A framework for decision making which considers changes based on clear objectives and an assessment of long term costs and benefits is desirable.
3 Principles of Taxation

Objectives, principles and methods of taxation

3.1 This chapter sets out five objectives of taxation (funding government, redistribution, macroeconomic stabilisation, behaviour change and growth and competitiveness). It then sets out four principles of taxation (simplicity, neutrality, stability and flexibility), and three broad methods of taxation (income, wealth and consumption).

3.2 These are all linked. Applying the principles to the different methods of taxation (and structures of taxation) should allow any country to meet the objectives of taxation in the most effective and efficient manner.

Figure 3.01 – Framework of objective and principles based tax system

3.3 However, there are often competing effects of taxation between these desired objectives and other considerations. The benefits of a robust and clear framework to base policy and reform decision making on – focussing on the costs and benefits the trade-offs – are set out at the end of the chapter.

3.4 For example, labour income taxes are generally believed to help macroeconomic stabilisation through their broad and diverse base and relative stability, whilst their potential to
deliver progressivity makes them important for tackling inequalities. However, they can have negative impacts on incentives to work and can have temporal effects which discourage savings.

3.5 Consumption and expenditure taxes are relatively efficient, simple to understand and collect, and can be used to encourage behaviour change. However, they can be regressive and therefore may be less suited to tackling inequality (notwithstanding the potential role for ‘negative’ taxes).

3.6 Wealth and property taxes can be economically efficient and effective in a growth orientated tax system, and can be used to redistribute resources across society. However, they may not be so apt at raising large sums of revenue as the tax base tends to be relatively limited.

3.7 These trade-offs highlight the importance of considering the entire system when analysing taxation. It is also important to consider related government spending such as in welfare where the spill-overs between taxation are significant. It is vital to ensure that, in all these areas, clear principles are established and followed to ensure the objectives are met in the most efficient manner.

Objectives of taxation

3.8 The central objective of taxation is to fund government services.

3.9 Governments collect a substantial proportion of national income in taxes, ranging from 25% to 48% across the OECD\(^{42}\).

3.10 However, taxation can also be used as a tool to influence behaviours to meet public policy objectives. Box 3.01 summarises some of the key uses of taxation.

\(^{42}\) OECD revenue statistics
Box 3.01 - Importance of taxation

Provision of public goods and services

The most basic motivation for taxation is to raise funds to support public spending, either for public goods (i.e. goods that otherwise would not be supplied by the market) or merit goods (i.e. goods that society believes should be provided for someone’s benefit irrespective of whether or not the market ‘could’ provide such a good).

Equity and redistribution

Equity objectives can range from providing a ‘safety net’ to support those on low incomes, providing temporary assistance in the event of an unforeseen event, through to more fundamental and comprehensive redistribution of resources (perhaps to counteract an imbalance in income/wealth created by other means). The linkages between the taxation and welfare systems are of crucial importance in these respects.

Macroeconomic framework

A stable but flexible fiscal framework is essential to delivering macroeconomic stability. Tax plays an important role, particularly as alongside the welfare system, it acts as an ‘automatic stabiliser’ on the economy.

Corrective activity and sustainability

Taxes can also be imposed with the aim of influencing behaviour, either if it is efficient to do so (e.g. in the presence of a market failure such as an externality) or if it is socially desirable to do so (e.g. discourage consumption of tobacco).

Growth, competitiveness and industrial policy

Finally, the tax system can also be used to support wider growth and competitiveness objectives. For example, it can be used to support industrial policy through targeting relative support for particular sectors or activities (for instance R&D). In addition, given that all countries have to raise some form of taxation, how a tax system is designed – and how efficient it is – can be an advantage against key competitors.
The Principles of Taxation

3.11 To meet the objectives of taxation in the most efficient and effective manner, it is important to consider the principles of a good taxation system.

3.12 Adam Smith famously set out four maxims with regard to taxes in the *Wealth of Nations*, first published in 1776:

- burden proportionate to the ability to pay;
- certainty;
- convenience; and,
- efficiency of collection.

3.13 While Adam Smith’s principles garner near universal support, studies have expanded them to increase the comprehensiveness of the principles and recognise the trade-offs in meeting different objectives of the tax system.

3.14 For example, the Mirrlees Review, set out that in formulating the objectives of a tax system, *for a given distributional outcome*, what matters is:

- Welfare and economic efficiency – the negative effects of the tax system on welfare and economic efficiency should be minimised;
- administration and compliance costs – all things equal, a system that costs less to operate is preferable;
- fairness other than in the distributional sense – for example, fairness of procedure, avoidance of discrimination, and fairness with respect to legitimate expectations;
- transparency – a tax system that people can understand is preferable to one that taxes by ‘stealth’.

3.15 The review concluded that a tax system which is simple, neutral and stable is best placed to meet these objectives.
3 Principles of Taxation

Box 3.02 - Scottish Government Approach to Taxation

The Scottish Government have set out their approach to taxation in Scotland – both in regards to the new responsibilities which will fall to Scotland under the Scotland Act, and under more ambitious constitutional aspirations.

The framework being advocated by the Scottish Government was set out in a statement to parliament by the Cabinet Secretary for Finance and Sustainable Growth. The approach is based on the four governing principles set out by Adam Smith, accompanied by the Government’s core purpose of delivering sustainable economic growth for Scotland and meeting the distinctive needs of Scotland.

Simplicity

3.16 A simple tax system is one in which tax rules and obligations are well known, easily understood, and where liability is clear. With a simple tax system, taxpayers can anticipate in advance and factor into their decision making, with minimal burden and uncertainty, the tax consequences of an action.

3.17 Simple tax systems improve transparency – and in turn political and administrative accountability. Easily understood systems minimise the burden to both taxpayers and the exchequer of administration and compliance.

3.18 A simple system is also fairer, in that it boosts accessibility. It also improves the integrity of the system by minimising the requirement for time and money to be spent on tax specialists to calculate or avoid tax burden.

3.19 Related to this, the principle of horizontal equity has the aim of ensuring that particular individuals or businesses undertaking broadly similar activities should be treated the same way. For example, there should be limited scope – without good reason – for preferential treatment of certain assets above others, or of earnings (e.g. employed or self-employed).

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3.20 Such biases extend to the treatment of corporate financing, with significant effects on the source of investment and funding, and the collection of tax revenues. For instance, with interest payments being tax deductible in many countries, including the UK and USA, debt financing is currently more favourable than equity financing for businesses, leading to ‘thinly-capitalised’ firms. Such biases need to be based on sound objectives and not lead to unintended consequences.

3.21 The scope and potential benefits of administrative simplicity is tied intrinsically to wider policy choices and the overall objectives of the tax system. However, by lowering administrative costs, all else equal, this allows for reduced tax burdens and/or increased expenditure.

Neutrality

3.22 The principle of neutrality aims to ensure that decisions should be made on merit, rather than on the basis of tax consequences. All taxes result in behaviour changes and distortions.

3.23 Neutrality is important in minimising negative or unintended effects of taxation – such as on labour supply decisions and the allocation of resources. It does not however, necessarily imply that the tax system should not be utilised to influence behaviours, especially where welfare and efficiency can be improved via taxes.

3.24 The neutrality of a tax system can be thought of in two ways. Firstly, in considering the effect of taxation relative to completely untaxed markets, and secondly in terms of the impact and consequences of different taxes relative to each other.

Stability

3.25 The stability and predictability of the tax system relates both to the stability of revenues which governments raise through taxation, and the stability of tax rules which face individuals and businesses.

3.26 In the first instance, a key aim of any tax system should be to ensure that the revenue stream from taxation should be relatively predictable at least to the extent that it meets a minimum level, in order to facilitate forward planning. Too many countries in recent years relied upon

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44 There are two exceptions to this, lump-sum taxes (largely a theoretical concept than a practical option) and the taxation of economic rents. These are examined later in the chapter.
3 Principles of Taxation

revenues from a small number of taxes – e.g. property transaction taxation in Ireland or financial services in the UK.

3.27 Stability of tax rules and procedures allows for predictability and certainty in the decision making and planning of individuals and businesses. This is especially important for investments which have high capital costs and long term time horizons such as oil and gas extraction.

3.28 Stable tax regimes reduce the administrative and compliance burdens which arise from alterations to the tax regime, and allow the legitimate expectations of business, investors and individuals to be upheld.

3.29 In addition to these three objectives, it is also helpful to consider another important objective, flexibility.

Flexibility

3.30 In light of evolving economic, social, and technological conditions, it is generally accepted that a tax system should be sufficiently flexible to be responsive to change – particularly in a dynamic and constantly evolving global economy.

3.31 One particular area of focus is the tax principles and frameworks for the digital age.

3.32 A well designed tax system strikes an appropriate balance between flexibility and stability, enabling a government to respond to changes while still creating a system which allows predictability and certainty.

Methods of Taxation

3.33 Taking these principles, governments have choices to make regarding the type of taxes used, the level and structure of the taxes, and upon who or what they are levied.

3.34 The taxes used and the coherence of the system ultimately reflect the objectives of the government.
At an aggregate level, taxes can be levied on income, wealth, and expenditure.

### Table 3.01 - OECD and UK/Scottish Tax Classifications

<table>
<thead>
<tr>
<th>Tax Category</th>
<th>Estimated share of Scottish Receipts (excluding North Sea)</th>
<th>OECD Classification</th>
<th>Scottish Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>54%</td>
<td>Taxes on income, profits and capital gains</td>
<td>Personal Income Tax</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Capital Gains Tax</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Corporation Tax</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Social security contribution</td>
<td>National Insurance Contributions*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Taxes on payroll and workforce</td>
<td></td>
</tr>
<tr>
<td>Wealth</td>
<td>11%</td>
<td>Taxes on property</td>
<td>Council Tax</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Stamp Duty** (Land and Buildings Transaction Tax)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Inheritance Tax</td>
</tr>
<tr>
<td>Expenditure</td>
<td>35%</td>
<td>Taxes on goods and services</td>
<td>Value Added Tax (VAT)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Vehicle Excise Duties (VED)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Alcohol Duties</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Tobacco Duties</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Air Passenger Duty</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Landfill Tax</td>
</tr>
</tbody>
</table>

Note: Table based on HMRC alignment of UK taxes with OECD classifications.
*National Insurance Contributions are made by both employee and employers. Although both are social security contributions, the employer contributions can also be thought of as a tax on payroll and workforce.
**Stamp Duty is a tax on property, but may also instead be considered an expenditure tax rather than wealth tax as it is a one-off tax levied on property purchases.
3 Principles of Taxation

Income Taxes

3.36 Taxes on income include taxation of labour income and non-labour income. In Scotland, they are estimated to account for over half of all total onshore tax receipts. Throughout the majority of countries they represent the ‘base-load’ of revenue raising – along with general consumption taxes - which are used to fund public services.

3.37 Labour income includes the salaries and wages of employees and self-employed individuals. Taxes tend to be levied through some form of personal income tax. Additional contributions can also be obtained, perhaps in relation to an entitlement to future public spending commitments, such as a state pension or unemployment insurance.

3.38 In many tax regimes, employers also make contributions in the form of payroll taxes. This impacts on the total tax bill on labour and has important implications for labour demand and supply (should the incidence ultimately fall on an employee through lower wages).

3.39 National Insurance Contributions in the UK tax system for instance, are levied on both the employee and employer.

3.40 Non-labour income includes rental income from capital and returns on other assets such as the ownership of land.

3.41 In such instances, it is helpful to draw a distinction between ‘normal’ rates of return, and ‘above normal’ rates of return arising from non-competitive markets or scarcity rents for depletable resources.

3.42 Above normal rates of return – or economic rents – are not subject to standard distortionary impacts of income taxation. For example, rents on activities such as oil and gas extraction will not, at least in principle, impact on behaviour (unless the tax rates are so high as to shift rewards from above normal to below normal rates of return). This is one reason why tax rates on the North Sea are so much higher than on other onshore economic activities in the UK.

3.43 See Box 3.03 for a summary of the principles of oil and gas taxation (as a particularly relevant case study for Scotland in managing economic rents).
Box 3.03 - Natural Resources – Oil and Gas Taxation Principles

The exploitation of finite natural resources (such as oil and gas) has several implications for economic policy and taxation.

- Firstly, oil and gas reserves are non-renewable and the optimal depletion rate needs to be managed;
- Secondly, the extraction of oil and gas typically involves various forms of externality;
- Thirdly, production typically generates substantial economic rents; and,
- Finally, since oil and gas reserves are part of a nation’s overall wealth, there should be sufficient compensation for society as a whole.

However, there is no specific definition of “significant compensation”. Moreover, these sectors exhibit characteristics that require special consideration including –

- Significant up-front and decommissioning costs;
- Benefits which can often be speculative and are secured over the long-term; and,
- Technical and financial risks.

Given these complexities, the policy choices for the collection of economic rents has been a key issue for governments around the world for many years.

Revenues from the exploitation of natural resources can take several different forms – e.g. specific taxes or charges (i.e. royalty payments), measures within the general tax system (e.g. ring-fenced Corporation Tax/Supplementary charge in the UK), or a degree of public-private ownership.

In general, an efficient tax system should capture the following fundamental objectives –

- appropriate state capture of rents;
- timely and dependable revenue;
- risk management;
- international competitiveness; and,
- administrative simplicity.

Appropriate Use of Revenues from Natural Resources

As outlined above, unlike other sources of national wealth, oil and gas reserves are non-renewable. By their very nature, once a barrel of oil or cubic metre of gas has been produced, they cannot be reproduced in the future.

It is important therefore to manage these revenues responsibly.

As outlined in our second report, a clear objective of the Scottish Government should be to establish both a short-term stabilisation fund and a long-term savings fund to maximise the economic opportunity of Scotland’s natural resources and ensure that the benefits are shared across future generations.
3 Principles of Taxation

3.44 Taxes are also levied on corporate income. This can be in the form of a direct corporate tax – i.e. paid by companies and organisations themselves – and/or taxation of any payments to the individual owners of such companies and organisations (such as through dividend payments).

3.45 In summary, taxes tend to be levied on many forms of income. However, there is often little consistency in how this happens in practice. Some have suggested the concept of a comprehensive income tax. A comprehensive income tax treats all forms of income the same, irrespective of its source.

3.46 In practice however, such a framework has proved difficult to establish, as it is hard to define what constitutes ‘income’ (e.g. should household production and leisure time be included). In Hong Kong for instance, a relatively simple definition of income is used covering only salaries and profits.

3.47 More fundamentally, there are many examples of where using different tax rates and structures for different incomes is useful and the arguments for differentiation are clear and proven. For instance, differing income elasticities and responses to tax cannot be allowed for in a uniform system.

3.48 However, there is a growing trend toward greater alignment to some degree – for example, the recent moves in the UK to more closely align employee national insurance contributions and income tax.

3.49 Changing economic, industrial and social structures may also alter the notion of what is termed ‘income’. For example, income flows are inherently more variable for certain groups of the population, such as self-employed and entrepreneurs. This raises questions around the appropriateness of taxing income based on yearly earnings – rather than, say, on an average base on earnings over a number of years.

3.50 Whilst developing a well-functioning system can be challenging, it can be delivered with careful planning and consultation.

45 Subsequent areas of the paper discuss how this might be done in practice
Wealth Taxes

3.51 Income represents the returns flowing from assets and factors of production. Wealth, on the other hand, can be obtained from owning a stock of assets. In addition therefore to the flow of income from wealth held, taxes can be levied on the store of wealth or the ‘cashing-in’ of such wealth.

3.52 It is often the case that a distinction is made between wealth accumulated by an individual/firm through their lifetime relative to that obtained through inheritance, gift or other transfer. This is made on both ethical and efficiency grounds.

3.53 Recurring wealth taxes are more generally levied on residential property, and to some extent, tangible personal assets. These are relatively easy to value and their immobile nature can make them an attractive item to tax, relative to other more mobile and complex assets.

3.54 Recurring property taxes are therefore relatively easy to observe and measure, which equates to high compliance, and are also considered a good tax in that they lead to relatively low economic distortions.

Expenditure Taxes

3.55 Governments also levy taxes on the consumption of goods and services. These account for over a third of estimated Scottish revenues.

3.56 There has been a general trend toward more dependence on such taxes in recent years – see Chapter 4.

3.57 These taxes can be placed on the purchase of specific goods and services – such as alcohol or tobacco products – or operate as a general consumption tax, such as VAT, covering a wide basket of goods and services.

3.58 In practice, governments often allow reduced rates or exemptions for particular goods and services. These are usually provided in situations where a government considers their purchase to be ‘essential’ or ‘desirable’. For example, key elements of food are often justified to be exempt from such taxes (or subject to a lower rate).
3 Principles of Taxation

3.59 While there are good economic, social and financial reasons for allowing such exemptions, in practice in many cases there appears to be no clear rationale for the decision taken. This can often lead to inefficiencies and a lack of transparency.

3.60 For instance, the ‘infamous’ distinction between the VAT on certain cakes and biscuits has led to long and costly legal cases over the interpretation of HMRC guidance around what constitutes a ‘cake’ and is therefore charged zero-rate of VAT opposed to the standard rate. It is therefore vital that such exemptions are carefully considered before being applied, particularly as political economy considerations can make them difficult to remove once established.

3.61 Expenditure taxes are often used to influence behaviours. ‘Pigouvian’ type-taxes are often applied to market activities which generate negative externalities (e.g. pollution) to bring the private costs in line with the social costs of the activity. Subsidies, or negative taxes, can also be used to encourage particular behaviours, especially if there are positive spill-over effects for which the benefits are not being fully captured by the producer.

3.62 Finding the efficient and optimal subsidy or tax to reflect ‘socially optimal’ levels can be highly challenging.

3.63 More generally, corrective taxes may be used to discourage behaviours which are seen as socially undesirable. Although not exclusively used to reflect costs imposed on wider society and the public purse, the potential rise and increasing costs of treating health related diseases may increase the importance of taxes on tobacco and alcohol, and the potential to tax unhealthy foods.

3.64 However, such attempts can face challenges. From a purely tax perspective, one such challenge is simply that many of the goods in question such as tobacco and fuel are price inelastic (i.e. demand changes relatively little as prices increases) and therefore taxing them may not be very effective in terms of achieving the stated objectives. Fuel duties in particular can have significant impacts on other government objectives - with negative economic consequences and impacts on equality due to their regressive nature.

3.65 On the other hand, it means such duties are very effective in raising revenues.
3.66 In the EU, the push toward a single market has led to a trend toward greater harmonisation of expenditure taxes. For example, there is now a minimum VAT rate of 15%, with exemptions or reduced rates specified by the EU or through agreement with the European Commission.

3.67 In the past, tariffs used to be deployed on the import of goods from overseas, often to support domestic economic activity. Collectively such taxes are prohibitive for economic growth in the aggregate as they limit the gains from specialisation and international comparative advantage.

3.68 International tariffs are now used relatively infrequently, with trade completely free in the EU and the WTO continuing to work to reduce trade barriers (both explicit and implicit) more widely.

**Box 3.04 - Direct and Indirect Taxes**

It is common to distinguish between direct and indirect taxes. One of the central debates in the design of a tax system is the appropriate mix between these two types of taxes.

Broadly speaking, a direct tax is a tax that is both imposed and collected upon a specific individual or economic agent. Most income and wealth taxes are defined as direct taxes.

An indirect tax in contrast, whilst often collected by one particular economic agent (e.g. a firm) are actually imposed on another. For example, indirect taxes include taxes such as VAT and other consumer taxes (i.e. the seller of a good collects the tax but the purchaser of the good pays the tax).

Direct and indirect taxes can lead to different implications, both economic and administratively, and therefore their distinction is important in considering the design and reform of a tax system.

A key issue in considering different types of taxes is to look at the so-called ‘incidence’ of a tax. The tax incidence captures who actually bears the burden of, or ultimately, has to pay, the tax (taking into account all subsequent fiscal and economic behavioural changes). This does not have to be the economic agent from which the tax is actually collected. For example, the tax incidence of an employer payroll tax may actually fall on employee rather than the employer if the net effect of such a tax is to reduce wages.

Ultimately, the incidence of a tax depends upon a number of complex interactions such as the elasticity of a tax and how temporary or permanent any change is viewed to be.\(^\text{47}\)

\(^{47}\) Impact of VAT reduction on the consumer price indices, Rob Pike, Mark Lewis and Daniel Turner, Office for National Statistics, Economic & Labour Market Review, Vol 3, No 8, August 2009
3 Principles of Taxation

Equity and Tax Structures

3.69 The tax system, alongside the welfare system, offers governments the means to redistribute income and wealth amongst the population. Ultimately, the degree of redistribution is a democratic choice, based on the socio-economic vision of the population. Tax structures however, are important for equality considerations, as they determine what share of an individual’s income or wealth is spent on taxation.

3.70 The structure of taxation can be thought of through the impact of changes in income (or wealth or expenditure) on the burden of tax.

3.71 Taxes can be structured in different ways. In theory, they can range from a lump sum tax which is charged at a constant rate irrespective of any characteristic (e.g. income, wealth or expenditure) to ones that vary in quite complex ways.

3.72 Lump sum taxes tend not to be practical – or indeed desirable – in most cases. So other forms of taxation tend to be used instead.

3.73 Taking income tax as an example. A proportional tax is one where the burden is constant across all incomes. With a progressive tax, the tax burden increases as income increases. A regressive tax is the opposite, and the tax burden falls as income rises.

3.74 To achieve these variations, tax rates can either increase at a constant marginal rate or certain rates can be applied across ‘brackets’, or ranges, of income. Within these ranges, tax rates will then vary.

3.75 A key challenge is that when tax rates change between thresholds, there can often be large swings in marginal tax rates. This is important as marginal tax rates are key drivers of economic behaviour. Care also has to be taken when considering ‘fiscal drag’ – i.e. the situation whereby natural growth in income (or wages) means that certain taxpayers move between higher thresholds and end up paying higher marginal rates of tax even if their overall standard of living has not changed.

3.76 The current framework of UK personal income tax aims to be progressive. Personal allowances on an individual’s first tranche of earnings, and three income tax bands with increased
marginal rates for higher income\textsuperscript{48} result in those earning more paying a higher share of their income in tax.

3.77 However, to understand if an individual’s total tax burden increases or decreases as income rises then the entirety of taxes paid must be considered, along with benefits from the welfare system. The opaque system of taxes and benefits for low income households was demonstrated earlier in the paper.

3.78 Expenditure taxes, such as VAT, are generally believed to be regressive when considered in isolation.

3.79 In terms of the share of income which is spent on VAT this is true, with those in the lower end of the income distribution devoting more of their income on average to VAT. However, the measure of regressivity could also be based on the share of individual or household expenditure. The IFS\textsuperscript{49} have shown that based on this measure, VAT is actually slightly progressive – as those with higher expenditure spend more on goods and services which are charged the standard rate of VAT. However, this is driven largely by the fact that richer households simply tend to spend more.

3.80 Individual taxes may differ in progressiveness, but analysis of equity implications should focus on the system as a whole – including the interaction with the welfare system – rather than particular taxes in isolation. This is particularly important in tax design and reform, where there are often opportunities to compensate ‘losers’ from one change through altering other parts of the system. If the changes lead to efficiency improvements, potentially everyone could become better off while the relative distribution of resources remain the same.

3.81 Inequality is also argued to have adverse impacts on both economic performance and social well-being. In his analysis on the links between inequality and growth, Professor Joseph Stiglitz concludes that countries which are more unequal do not do as well, do not grow as well and are less stable\textsuperscript{50}.

\textsuperscript{48} http://www.hmrc.gov.uk/statistics/tax-statistics/table2-6.xls
\textsuperscript{49} http://www.ifs.org.uk/budgets/gb2009/09chap10.pdf
3 Principles of Taxation

**Tax and Economic Growth**

3.82 Alongside the potential benefits of improved equality, the tax system is also a key lever in the determinants of economic growth. In general, a growth-oriented tax system should create as few obstacles as possible to the growth of economic activities, subject to meeting other objectives of the tax system.

3.83 At the same time however, government spending can itself be growth enhancing – for example, investment in infrastructure, education and skills.

3.84 In altering the returns to employment and investment, taxes have the potential to discourage/incentivise risk-taking, entrepreneurialism and innovation, and to influence the returns to labour, investment and migration (both domestic and international workers to and from an economy).

3.85 Trade-offs invariably exist between the degree to which the system is designed to minimise any negative efficiency effects from taxation, and the goal of raising sufficient revenues to fund public services (which themselves can be growth enhancing) and to redistribute income and wealth.

3.86 Tax systems can contribute to the creation of an attractive business climate, both through the design of the system and minimal administrative and compliance burdens, and also with competitive rates to encourage investment.

3.87 Tax policy forms a fundamental aspect of a country’s industrial policy in helping shape the desired economic structure, which can have knock on effects on creating sustainable and balanced growth in output.

3.88 Favourable tax treatment of activities which generate positive externalities, such as research and development, and similarly relatively high taxation of activities which create negative externalities, can all shape a favourable industrial landscape and promote balanced and sustainable growth.

3.89 Taxes, along with the wider welfare and public service system, are also important for labour market outcomes.
3.90 In simple terms, the key determinants of the output of an economy are productivity growth and the utilisation of labour (through labour market participation and population growth). Both are affected in some way or another by taxation and the government spending that it funds.

3.91 Improvements in productivity reflect the level of available capital – physical and human – and how it is used. As an economy becomes more efficient and innovative its productivity increases, helping to drive economic growth.

3.92 Taxes can impact on the performance of productivity through influencing the level and type of investment in the economy (e.g. corporate taxation, tax reliefs on interest payments); encouraging innovation (e.g. R&D credits, capital gains taxation); the mobility of the workforce; and how much individuals choose to invest in skills and education (e.g. income taxes, expenditure taxes, tax breaks – on education and training).

3.93 The utilisation of labour is also important to economic output (not just the size of the workforce but also hours worked).

3.94 The type and level of labour income taxes – and the corresponding benefits from welfare – influence whether individuals choose to participate in the labour market; the numbers of hours’ individuals choose to work; and the type of work an individual participates in.

3.95 It is also vital for the quality of work and the value placed on worker input, which is in turn a key determinant of growth. An economy with fuller levels of employment which is skilled and motivated will boost output over other models.

3.96 Along with increasing economic output, encouraging employment is also a key to tackling inequalities and lifting people out of poverty. Social outcomes improve not only as a result of high levels of employment, but through a system which provides good employment and decent wages.
3.97 Figure 3.02 highlights how different elements of the tax system can be used to influence the drivers of economic growth – both through level effects (labour utilisation) and dynamic effects (productivity).

3.98 Different taxes impact on these determinants in different ways. For instance, consumption taxes are considered to have a more neutral effect on the timing of expenditure compared to income taxes – and therefore impacts less on savings decisions. Increased saving frees up economic resources for investment and may be expected to increase future national income\(^52\).

3.99 Ranking taxes according to the impact on economic growth, the OECD\(^53\) find that recurrent taxes on the least mobile factors (i.e. immovable property) appear to be the least damaging to growth, followed by consumption taxes, personal income taxes, with corporate taxes being the most damaging to growth.

3.100 However, the OECD\(^54\) point out that there are a number of factors which will determine the impact of tax reform on growth in different countries and circumstances, and it is generally difficult to assess the overall effect of an isolated tax reform on economic output for a number of reasons.

- Firstly, changes in taxation will often affect multiple determinants of GDP – for instance a reduction in labour income tax may increase employment, but can also increase the opportunity cost of higher education with knock on effects to labour productivity.

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\(^{51}\) Tax Policy Reform and Economic Growth, OECD, 2010
\(^{52}\) The Economics of Taxation, James and Nobes, 2013
\(^{53}\) Tax Policy Reform and Economic Growth, OECD, 2010
\(^{54}\) ibid
Secondly, tax reforms predominantly occur at the same time as other changes to tax instruments making it challenging to disaggregate the often competing effects.

Also, and importantly in terms of considering a whole system approach, the impact of changes in taxation often depend on the design of other policies and institutions.

3.101 Ultimately it is therefore about getting the right balance and mix of taxes in place.

3.102 Finally, as highlighted above, the investment and use of revenues from taxation is itself a driver of growth. For example, taxes support government spending on crucial infrastructure investments and the provision of public goods such as funding education and skills development.

**Box 3.05 – Rent-Seeking**

Rent-seeking is where resources are spent in order to increase one’s share of existing wealth rather than creating new wealth. Rent-seeking is inefficient and distorts resource and wealth allocations.

In the simplest form, rents received from rent-seeking practices involve a redistribution of resources from one part of society to another. This can often be inefficient and unfair. Depending upon the nature of such rent seeking it can also contribute to increases in income inequality. As noted, in his analysis on the links between inequality and growth, Professor Joseph Stiglitz concludes that countries which are more unequal do not do as well, do not grow as well and are less stable.

This has important implications for the debate about taxation of high earners. If some people with very high incomes are deemed to be participating in rent-seeking, higher rates of tax for such individuals will only have a limited ‘economic’ impact and may, instead, reduce the benefit from rent-seeking behaviour and thereby distortions in an economy. Finding this point in the income distribution is a key challenge. Some recent research does suggest that cutting top tax rates have only a very limited impact on growth and instead show a correlation between cuts in top tax rates and increases in income inequality. However, it can be difficult to identify rent seeking in practice, particularly in highly regulated or concentrated markets.

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55 Stiglitz, J. (2013) *The Price of Inequality*
Whilst tax avoidance is the most obvious form of rent-seeking in taxation, specific breaks given to industries, variations in tax rates favouring particular groups etc, all may form part of rent-seeking. Although a well-designed tax system will use different rates and structures for different taxes, it is important that the design of the tax system minimises the opportunities for rent-seeking. The more complex and inconsistent the tax base, the more rent-seeking activity will take place as tax avoidance becomes easier. As the Mirrlees report concluded, arbitrary differentiation in the tax treatment of people and forms of economic activity should be avoided unless there is a compelling case to deviate.

A framework for decision making in Scotland

3.103 With independence Scotland would be required to design its own tax system. Although there will be limited scope for radical change on day one of independence, it would be practical to take full operational control of a number of taxes, and also to alter policies (such as rates etc) around the margin for certain taxes such as income tax and corporation tax.

3.104 The transition period would provide the opportunity to consider and consult widely on what the tax system in Scotland should and could look like. The two taxes devolved by the Scotland Act 2012 and the power to set a Scottish Rate of Income Tax provide examples of how the time between the decision to transfer powers and the implementation of those powers can be used to consult widely and ensure both the policy and collection mechanisms are correct when the taxes become operational.

3.105 In deciding which taxes should be changed and how, the government should use a framework for decision making which is built around the five objectives of taxation and the four principles of a good and effective tax system set out earlier. (See Figure 3.01)

3.106 All policy making decisions should make clear which of the five objectives the policy is targeting, and consider if there is a more effective and efficient way of achieving them based on the principles set out in this paper.

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3.107 For instance, a policy decision should be based on how it affects revenues, equality, macroeconomic stability, competitiveness and behaviour changes the linkages between these areas and if there is a more efficient way of meeting the desired objective (including methods other than taxation).

3.108 Decisions should be based on the costs and benefits (not just in the short-term but also the medium to long-term) to the whole system (including other areas of government policy such as welfare), and not just a partial view of particular impacts, or considering only the impacts in terms of the amount of revenue a tax will raise (or lose) and identifying winners and losers.

3.109 Such a framework would keep the system focused and principles based – and prevent the build-up of legacy and imbedded taxes which no longer meet their original aims.

3.110 The use of time limited tax concessions, with on-going monitoring and reviews, would ensure that the whole system remained comprehensive and aligned.

3.111 Such a framework could be used across the whole of the public sector, building a focused and clear model to work from which enhances understanding across the entire system. This would facilitate the streamlining of institutions involved in the tax, welfare, public expenditure and macro-economic stability domain, which would be working to the same clear methodology.

**Conclusions**

3.112 The tax system – in conjunction with other policies such as social welfare – can be used to shape outcomes that reflect the socio-economic vision of a country. It also plays a crucial role in any macroeconomic framework and industrial landscape.

3.113 For a given set of objectives, a tax system which is simple, transparent, stable and easy to follow minimises administration and compliance costs, maximises tax-take and boosts investment and growth.

3.114 Different methods of taxation – income, expenditure and wealth – and the structure of individual taxes used can be designed to meet the objectives of the tax regime in a clear and principled manner.
3 Principles of Taxation

3.115 If Scotland was to get such design right, this could represent a major advantage, offering a more robust and efficient tax system than key competitors.

3.116 In designing the tax system, a framework for decision making based on the five objectives of taxation set out above and consideration of the long term costs and benefits will keep the system focused on the principles of a good tax system. This will facilitate joined up policy making across the tax and welfare sphere and institutional landscape.
4. International Trends in Taxation

Chapter Summary

- There are substantial variations in the design and scope of international tax systems, reflecting distinct socio-economic visions across countries.
- The ratio of taxation raised relative to GDP ranges from 48% in Denmark to around 25% in the USA.
- Direct taxes typically dominate indirect taxes in terms of their overall contribution to revenues, though there are substantial variations between countries.
- Some key trends have emerged in recent years. For example, there has been a move toward general consumption taxes (such as VAT) in place of specific taxes on certain items. The overall tax base has also been broadened.
- Broadening the tax base through the removal of certain exemptions and allowances, has often been accompanied by reductions in the headline tax rates – rather than an increase in the overall tax burden.
- In part, and as a result of the increased mobility of international capital, corporate tax rates have fallen. There is now more of an acceptance of the need for greater international cooperation of tax administration, although there is still some way to go before an effective system is operational.
- Recent reforms highlight some of the challenges involved in making fundamental changes to tax systems – but also offer important lessons for Scotland.

4.1 International trends in taxation over the last 30 years and international ‘models’ of taxation illustrate the rich variation in tax regimes that currently exist. What this evidence shows is that whilst economies face similar challenges and opportunities, they approach them in their own unique way.

4.2 Recent reforms highlight some of the challenges involved in making fundamental changes to tax systems. They offer up lessons such as the importance of timing, the use of independent experts
and extensive consultation, and the need to evaluate the impact of changes at the aggregate level, not just on the isolated effects of individual taxes.

**International variations**

4.3 A simple examination of the composition of taxation internationally – both in terms of the share of different taxes and the total level of taxation as a share of GDP – illustrates the variety of approaches countries take to raising taxation.

4.4 Chart 4.01 illustrates the international variations in the mixture of tax receipts.

4.5 Personal income taxes, social security contributions, and taxes on goods and services form the substantial share of tax receipts in the majority of OECD countries. However, there are significant variations across countries in the balance of these taxes.

**Chart 4.01 – Tax by category as % of total receipts, 2011**

Source: OECD revenue statistics

4.6 Chart 4.02 illustrates the international variation in the proportion of taxation raised relative to the size of economies. This ranges from nearly 50% in Denmark to around 25% in the United States.
4.7 In 2011, the estimated amount of tax collected in Scotland represented over 35 per cent of total Scottish GDP (including a geographical share of North Sea oil). This is broadly similar to the corresponding outturn figure for the UK.

4.8 Interestingly, evidence suggests that compliance costs are not perceived to be improving over time\(^\text{59}\).

4.9 Indeed, a US study\(^\text{60}\) has shown that while overall regulatory costs (environmental, economic, workplace, health and safety, and tax) for all businesses decreased by 15\% in the period from 1992 to 2000, the tax element of such regulatory costs increased by 25\%. Similar conclusions are documented by the European Commission\(^\text{61}\).

\(^{59}\) Blumenthal and Slemrod, 1992; Evans, 2003

\(^{60}\) Crain and Hopkins, 2001

Recent trends

4.10 The rising importance of social security contributions and general consumption taxes, such as VAT, as a method of raising revenues across the OECD is shown in Chart 4.03.

Chart 4.03 – Share of tax receipts by type of tax, OECD Unweighted average, 1965-2010

Source: OECD revenue statistics

4.11 Corporate income and property taxes are overall relatively less important, making up a smaller composition of total tax receipts. They also show little variation in their share of revenues over the period since 1965.

4.12 The UK tax system has demonstrated a similar trend, with its movement towards VAT and the increase in share of revenues from National Insurance Contributions.

Personal income and social security contributions

4.13 Personal income taxes and social security contributions form the largest share of tax receipts, on average, across the OECD. Combined, they average over half of all government tax revenues.
4.14 The share of total receipts raised through the total personal ‘tax wedge’ (taxation of personal income and employee and employer social security contributions) has remained broadly stable over the last 30 years, with a slight fall from just over 55 per cent of receipts in 1980 to around 50 per cent over the 1990s and 2000s. However, over this period there has been a shift away from revenues from personal income towards social security contributions.

Chart 4.04 – Share of tax receipts by type from personal income tax, 1980-2010

Source: OECD revenue statistics, GERS

4.15 In Scotland, such taxes are estimated to make up a lower share of total onshore receipts, averaging around 45 per cent over the previous decade. As a proportion of overall onshore tax receipts, income taxes and social security contributions (employee and employer NICs) are estimated to have averaged in the range of 42% to 48% since 1980.

4.16 The variations are predominantly down to changes in the share of personal income tax, while receipts from social security contributions have remained relatively stable.

4.17 Although the overall share of labour tax receipts has remained relatively constant, there have been substantial reforms in the structure of personal income tax, including reductions in the number of rates and particularly the level of the statutory top rate of personal income tax.
4 International Trends in Taxation

4.18 The average marginal top rate of personal income tax across the OECD was 41.5 per cent in 2010, a significant reduction from 30 years previously when rates of over 70 per cent were not uncommon

![Chart 4.05 – Top statutory marginal personal income tax rates, 2012 and 2010](source: OECD revenue statistics)

Corporate income taxes

4.19 Across the OECD, receipts from corporate income tax have remained relatively stable, averaging between 7.5 and 10.5 per cent of total receipts since 1965. This is significantly less than receipts from personal income taxes, social security contributions, and taxes on goods and services.

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4.20 Estimated Scottish (onshore) corporation tax receipts, as a percentage of total onshore receipts, have averaged around 8% over the last 30 years. Across this period, the share has fluctuated from just over 4% in 1981 to over 11% in 1989.

4.21 Corporation tax rates have fallen across the OECD in recent years. Between 2000 and 2013, 31 of 34 OECD members reduced their top statutory corporation tax rate. Only two increased it. Over this period, the average headline rate fell from 32.6 per cent to 25.5 per cent.\footnote{OECD tax database. Includes compulsory levies and sub-central government corporate tax. Unweighted OECD average.}

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\footnote{OECD tax database. Includes compulsory levies and sub-central government corporate tax. Unweighted OECD average.}
4.22 It should be noted that this cannot be directly interpreted as a race to the bottom. While rates have reduced, there is evidence of base broadening through simplifying the deductions and allowance regimes. This may explain, in part, why the overall share of revenues from corporation tax has remained relatively flat across the OECD over the period.

4.23 There are important links between personal income taxes and corporate income taxes.

4.24 Differences between the levels of personal income tax and corporate and capital taxes may incentivise the structuring and organising of income to minimise tax liabilities.

4.25 In the UK, the top marginal rate of personal income tax is 45 per cent, while the standard rate of corporation tax is due to fall to 20 per cent by 2015. The corresponding rates in New Zealand have been partially aligned to 33 per cent and 28 per cent respectively, to increase the coherence of the system and minimise the incentives to structure income in a manner as to minimise tax (i.e. declaring personal income as business income).
4.26 The classification of corporation taxes and personal income taxes has been a long running issue in the UK.

4.27 As Chancellor of the Exchequer, Gordon Brown raised the Small Companies Rate (SCR) of corporation tax by 3 percentage points between 2007 and 2009 to reduce the differential between incorporated and unincorporated businesses – with the Budget 2007 document stating that it had “become apparent that the SCR can be taken advantage of by people incorporating with the main aim of reducing their personal tax and national insurance liability by extracting labour income as dividends.” This resulted in an “unfair difference between the overall tax and NICs paid by the incorporated and the unincorporated, even where they are engaged in the same economic activity.”

4.28 Differences in the rates are manageable, but require increased monitoring and administration to ensure the correct classification of earnings.

4.29 Multiple approaches are operated in taxing businesses operating across different jurisdictions. Key is defining the appropriate tax base and working out where the true liability for such activities is located.

4.30 International examples also highlight the potential mechanisms that Scotland and the rest of the UK could put in place to reflect the close integration of both economies. This can help maximise revenue collection and minimise the collection burden.

4.31 A coordinated approach using commonly defined and measured tax bases can reduce the compliance costs for both businesses and tax administrations. This could also ensure that there are lower opportunities for business to avoid paying taxes, or alternatively have the same profits subject to taxation more than once. This is likely to be where international developments make progress in the short to medium term.

4.32 Importantly, the tax rate and allowances on the commonly measured base remains fully the domain of the individual authorities and can vary across the multiple jurisdictions.

4.33 Going one stage further, formulas can be used to apportion taxable profits across jurisdictions. In the United States, individual States are recommended\(^\text{65}\) to apply equal weighting between the proportion of sales, employment and property of a business within its borders in determining a share of the overall profits to tax. Over time however, states have become inclined to give increased weighting to sales in calculating a share of the profits to tax although the principle still holds\(^\text{66}\).

4.34 The European Commission has proposed a consolidated common corporate tax base with formula appointment\(^\text{67}\) across the EU. Tax returns would be filed with a single EU administrator, who would take into account allowances and before distributing taxable profits to member states using an agreed formula.

4.35 Other cost effective policies are also in evidence in other countries. For example, the Basque Country in Spain has an especially high degree of tax autonomy – including over collection. The treatment of corporation tax for entities which operate across both Spain and the autonomous region of the Basque Country is set out in an economic agreement between the two authorities\(^\text{68}\).

4.36 Small businesses with turnover less than 6 million euro pay tax to the authority in which their tax address resides – irrespective of where it carries out its transactions.

4.37 For Basque resident enterprises with turnover greater than 6 million euro, tax is paid according to the share of business they conduct outwith the Basque Country. Entities which undertake more than a quarter of their transactions in the rest of Spain settle their taxes with both the local and central tax administrations, with taxes levied on the share of transactions carried out in each territory.

4.38 These examples highlight potential mechanisms for Scotland and the rest of the UK to develop practical and workable models for future tax administration.

\(^\text{65}\) [ITEPnet.org/pdf/pb11ssf.pdf](http://itepnet.org/pdf/pb11ssf.pdf)

\(^\text{66}\) Ibid

\(^\text{67}\) [EC.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/](http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/)

\(^\text{68}\) [www9.euskadi.net/fiscalidad/impuesto_sdares_i.htm](http://www9.euskadi.net/fiscalidad/impuesto_sdares_i.htm)
Consumption taxes

4.39 The overall proportion of tax revenue from taxes on goods and services increased slightly over the ten years from 1965 to 1975. Since 1975, the share of taxes from goods and services has remained broadly stable, accounting for around 35 per cent of receipts across OECD members.

4.40 While the overall share remained steady, there has been a shift away from taxes on specific goods and services towards general consumption taxes, such as VAT.

4.41 General consumption taxes have nearly doubled from just over 10 per cent of total receipts in 1965, to almost 20 per cent in 2010. There has been a corresponding fall in taxes on specific goods and services, from over one fifth of all tax receipts in 1965 to around one tenth in 2010.

4.42 The average general consumption tax rate has increased across the EU and OECD over the last decade. The average EU VAT rate had risen to above 21 per cent by 2012 and to around 14.5 per cent in the OECD (excluding the EU).\(^{69}\)

4.43 This has been accompanied by a general broadening of the tax base,\(^{70}\) particularly by the removal of exemptions and reduced rates for particular goods and services.


\(^{70}\) ibid
Box 4.01 - VAT Revenue Ratio

An indicator of the breadth of the tax base is the notion of the VAT revenue ratio.

This expresses the revenue collected from VAT as a proportion of the revenue that would be raised if the headline VAT rate had been applied to all consumption. That is —

$$\text{VAT revenue ratio} = \frac{\text{VAT revenue}}{\text{rate} \times \text{consumption}}$$

The ratio is equal to 1.00 if there is a single rate, broad-based, and perfectly enforced.

Chart 4.08 – VAT revenue ratio (2006)

Source: IMF (Tax Policy Options for Fiscal Sustainability: Michael Keen, 2011)

A high ratio suggests a uniformly applied rate of VAT across all goods and services — a broad base.

In practice, the revenue ratio averages (mean) is above 50%, although there are big variations across countries.

4.44 A general and broad consumption tax base – with a standardised rate across all products and services – may be considered more economically efficient in that it does not distort the expenditure and consumption patterns of consumers, which should theoretically maximise consumer surplus.
4.45 Of course, it is both to encourage – or discourage – the consumption of certain goods and services, and to meet equality objectives, that not all countries use a uniform consumption tax.

4.46 In summary, there has been a trend in recent years toward greater harmonisation of tax across different goods and services and less evidence of policy makers’ picking and choosing what goods should be taxed at what amount. This is of course controversial, particularly as certain people lose out from such changes or particularly if goods have political, social, economic or ‘fairness’ characteristics attached to them.

4.47 In these instances, alternative sources of redistribution – e.g. through welfare – are required to act as a counterbalance.

Property taxes

4.48 Property taxes include taxes on immovable property, taxes on net wealth, estate, inheritance and gift taxes, taxes on financial and capital transfers. In the UK and Scotland this includes council tax, stamp duty land tax, inheritance tax\(^{71}\) and so forth.

4.49 Across the OECD, the share of property taxes has remained relatively constant since 1980, making up between 5 and 6 per cent of total government revenues.

4.50 Again however, there is significant variation between countries, with the USA and the UK having the largest share at nearly 13 per cent and 12 per cent respectively. In contrast, property taxes comprise just over 1 per cent in Estonia and Austria.

\(^{71}\) Inheritance tax applies to an individual’s entire estate, not only property. It is payable if the estate is valued over the current Inheritance Tax threshold (£325,000 in 2013-14).
‘Models’ of taxation

4.51 There are a variety of tax systems internationally, reflecting the assortment of objectives, preferences, and unique circumstances of different countries.

4.52 Different taxes and their structures – levels and tax bases – are used in meeting the objectives of the tax systems. Although no two countries have exactly the same tax system, certain systems are based on similar principles and can therefore provide lessons to draw on -

- Broad based/low rate
- Dual income model
- Flat tax model

4.53 One example is a broad based/low rate system - New Zealand is a prime illustration of this type of tax system - which attempts to ensure most activities are subject to taxation by using minimal exemptions and allowances. New Zealand for instance, has no personal tax allowance and the majority of goods and services are charged tax at the same standard rate.

4.54 All things remaining equal a broader tax base means that the rates of taxation can be lower for a given level of revenue. This can help reduce efficiency losses, which evidence shows increase with higher rates, and also help make the revenue collected more resilient.

4.55 It can also minimise compliance and administrative costs by making collection transparent and straightforward72.

4.56 If tax avoidance increases at an accelerating pace as the marginal tax rate rises, using a wider spread of taxes, each with lower rates, has the potential to ensure greater collection of revenues.

4.57 Chart 4.09 illustrates that with broader tax bases – lower tax rates can produce higher revenues as a share of GDP. For instance, in 2011, New Zealand had a headline rate of 15% for the GST (Goods and Services Tax) which raised revenues equivalent to 9.9% of GDP. The higher rate of VAT in the UK, 20%, raised revenues equal to 7.3% of GDP.

Against this however, it limits the scope, to a degree, to target particular tax policies to particular circumstances and needs to be accompanied by proactive policies such as welfare and other government support to counterbalance a lack of progressivity in the tax policy.

Dual income tax models – also known as Nordic income tax due to their development in Scandinavia – are distinguished by their separate schedules for personal income taxes and the more mobile capital and corporate income bases, the latter being taxed at a lower rate and on a proportional scale, while personal income is taxed using a progressive schedule.

Such models require greater monitoring and tighter rules to ensure adherence as there are greater incentives to shift income between categories to benefit from reduced rates.

Flat tax models involve a single rate for each type of tax i.e. a flat rate of income tax, corporation tax and VAT although not necessarily at the same rate. Flat taxes reduce the complexity of the tax system and aim to improve efficiency. However they are regressive in nature and the tax burden is larger for the least well-off.
Conversely tax systems can be designed to be more progressive in nature and have a narrower tax base, with welfare policy playing a smaller role in redistribution.

Tax systems can also be designed with specific policy objectives, for example the Irish tax system with a 12.5% corporation tax rate could be considered an example of a tax system designed around an overarching aim of attracting foreign direct investment.

In reality, most systems are a hybrid of different approaches to tax policy and apply a wide variety of alternative models and frameworks in an attempt to design a system that is best suited to a country’s particular characteristics and circumstance.

Recent Examples of Tax Reform

Reforms to tax systems in 2011 and 2012 across the EU have largely been targeted at reducing government deficits. Many member states have increased personal income taxes, social security contributions and VAT rates, although the trend to cuts in corporation tax has continued, albeit at a slower rate.

Whilst these reforms have been influenced by the general economic conditions, political and social factors can also play a role in tax policy. Evidence suggests that hysteresis is present in tax policy which favours certain groups, i.e. tax relief, reduced rates etc, and that political considerations favour the status quo. In particular even where a specific group did not initially lobby to benefit from a policy, there may be difficulties removing benefits at a later time.

When considering reform of the tax system it is particularly important to view any single tax policy as part of the wider tax system. This allows the overall impact on groups within the population to be accurately assessed. Similarly reforms which improve transparency in the tax system can also increase accountability of the body determining tax policy as understanding of the tax system improves.

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4.68 The experiences of more specific reforms provide interesting case studies. Denmark recently undertook a process of tax reform as part of a wider macroeconomic adjustment programme which aimed to reduce the government deficit. From a tax perspective, the key reform was to widen the tax base through lowering the income rate thresholds and removing the deductibility of interest payments from income tax, while at the same time lowering tax rates.

4.69 Phased introduction of the changes were used to make the reform politically manageable – with the reduction in interest deductibility from personal income tax phased in between 2012 and 2019 – while the tax cuts happened immediately.\(^7^5\)

4.70 Denmark also appointed a Tax Commission to develop proposals for reform – demonstrating the importance of institutional arrangements in reform design and implementation.

4.71 Considerable issues have been identified in the UK tax system, with comprehensive reviews identifying the need for substantial reforms to establish a clearer and principles based system. However, the response of successive UK Governments has been focused around the margins, such as the establishment of the Office for Tax Simplification to review certain tax exemptions and allowances and particular areas of the tax system.

4.72 The Henry Review\(^7^6\) looked at the Australian tax system. It reported its findings in 2010. The key recommendation was for the introduction of a Resource Super Profits Tax – a tax on the rent from the extraction of non-renewable resources. Opposition from industry and other stakeholders led to a watered down final proposal, with greater exemptions and deductions, resulting in expected revenues falling well below original estimates.

4.73 In 2006, Belgium introduced an allowance for corporate equity\(^7^7\) in an attempt to remove or reduce the current biases in favour of investing in certain assets that are treated more favourably by the capital allowance regime, reduce bias towards using debt finance over equity finance, and increase investment by aligning the tax implications of current expenditure – which is currently tax deductible – and capital expenditure.

\(^7^7\) Alternative systems of business tax in Europe, Mooij and Devereux, European Commission Taxation Studies 17
4 International Trends in Taxation

4.74 A particular trend has been attempts to broaden the tax base, this has been undertaken by a number of countries.

4.75 Two countries that have taken significant reforms to their tax system include Ireland and New Zealand. Both countries have gone through a process of widening their tax base.

4.76 Box 4.02 illustrates the challenges that Ireland faced in the recent recession and illustrates the problems of a tax base that has become too narrow through exemptions and allowances.
Box 4.02 - Narrowing of tax base and introduction of Universal Social Charge (Republic of Ireland)

The narrowing of the tax base through a plethora of exemptions and allowances can create a situation whereby a country’s public finances are subject to risk.

This was particularly true in the case of Ireland. By 2010 for example, almost half of income earners in Ireland were not liable to pay income tax.

Compounding this, receipts from property transaction taxes represented a disproportionately high share of revenues – rising from 2% of revenues in 1984 to 8% in 2006\(^78\). With the onset of the global financial crisis, the volume and value of the housing market in Ireland collapsed, and receipts from property transfers reduced correspondingly, falling from 3.7bn Euro in 2006 to under 1bn Euro in 2009\(^79\).

In response, Ireland has embarked on a series of reforms. This included the introduction of the Universal Social Charge (USC), a tax on income, in 2011\(^80\).

4.77  The example of Ireland illustrates the danger in narrowing taxes to such a degree that revenues are left vulnerable to macroeconomic shocks. Striking a balance between the simplicity of the tax system, along with ensuring the stability and sustainability of revenues, is therefore required.

4.78  From a theoretical perspective, base broadening tax reforms are generally seen as growth-orientated as they can allow lower marginal tax rates.

4.79  Moreover, moves away from labour taxes to comprehensive consumption taxation (i.e. with fewer exemptions but reduced rates) provide an avenue to effectively broaden the tax base, boost incentives and simplify the system.

4.80  However, they may have distributional consequences which can limit their application in practice. It can be argued that the correct solution in such instances is to provide properly targeted compensation through other aspects of the policy spectrum to those who may be disadvantaged by such reform. As a result, the net effect on these individuals can be mitigated and even enhanced.


\(^79\) ibid

Box 4.03 - New Zealand tax reform

The tax framework in New Zealand is based around the principles of ‘Broad base, Low Rate’, with a Goods and Services Tax (similar to VAT) applying to most consumption goods, alongside a broad income tax covering most types of income. New Zealand has no general capital gains taxation\(^81\), and no land tax or social security contributions\(^82\).

Prior to this, gradual changes to corporate and personal income taxes had led to a complex and poorly aligned tax system with high marginal tax rates.

Concerns that New Zealand’s tax system had become incoherent and internationally uncompetitive led to significant tax reform which started in the 2010 Budget.

This led to the establishment of a Tax Working Group (TWG) - an independent body of expert tax practitioners, academics, and business leaders in conjunction with the NZ Government\(^83\).

Many of the recommendations of the group were put in place in the 2010 Budget including\(^84\):

- Aligning the top rate of personal income tax and trustee tax rate. The top rate of personal income tax was reduced from 38% to 33%, while the marginal rates in the lower bands were also reduced.
- Reducing the rate of corporation tax from 30% to 28%, closing the gap with the top rate of personal income tax to 5 percentage points.
- Increasing the GST rate from 12.5% to 15%, while compensating low income households through other aspects of the tax and welfare system.

4.81 Base-broadening can also be accomplished via more modest changes to the tax system.

Identifying gaps in the system where income – in the widest sense – is being derived but not subject to the right amount of taxation.

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\(^81\) Some investments, such as personal property and land purchased for the purpose of realising a profit through resale are liable to capital gains tax. Receipts raised through the tax are relatively minor, reflecting the challenging in proving the intent of releasing a capital gain at the time of purchase.

\(^82\) A compulsory accident insurance levy is levied on employees and employers. In 2013-14 the rates for employers and employees are 1.15% and 1.7% of liable earnings respectively. It is administered by the Inland Revenue on behalf of the Accident Compensation Corporation [http://www.acc.co.nz/](http://www.acc.co.nz/)

\(^83\) New Zealand Tax Working Group, University of Victoria

\(^84\) New Zealand Budget
4.82 Movement towards a broad tax base does not require, or make it optimal, for all tax reliefs to be abolished. Preferential tax treatments have costs and benefits, and these should be evaluated to ensure the benefits from targeted tax reliefs outweigh the costs of reduced simplicity and loss of revenues.

4.83 This approach allows for reliefs which are considered important for meeting core objectives of growth, employment and social equality. But the key point is that such reliefs are targeted at the core issues needing to be addressed and are well considered and fully informed.

4.84 All else equal, broadening the tax base also allows tax rates to be lowered – rather than necessarily increasing the overall tax burden.

4.85 Fundamental tax reform is politically difficult as there are inevitably winners and losers, or at least the perception that there will be. Scotland will have an opportunity to improve the tax system with independence – however it is likely to still face pressures when introducing change, especially as it would be inheriting the UK system.

4.86 However, independence offers a unique opportunity to undergo beneficial changes, before the legacy system again becomes entrenched. This includes the need for early and clear communication of the direction which the government and parliament intends to move the tax system – and the principles behind this. This also gives time for ample consultation.

4.87 The case studies also illustrate the importance of communicating that reform should be evaluated in terms of its overall impact – not just the effect of individual changes and particular taxes and benefits.

4.88 Independent bodies can also be used to calculate the effects of tax proposals on the behaviour of individuals and businesses, tax revenues, and the distribution of income. It has been argued that this provides a level of scrutiny and accountability which can improve the drafting of legislation and increase the prospects of reform being achieved. The establishment of a tax forum in Scotland, would bring increased credibility and transparency to the design of any future Scottish tax system.

85 Alt, Perston and Sibieta (2008)
Innovation in Tax Administration

4.89 The constant development of new technologies and new channels of media provides opportunities for tax administration bodies to improve their services.

4.90 Many countries are now using social media to communicate with customers and to promote particular policies. In the UK, Twitter has been used by HMRC to raise awareness of deadlines for Tax Credit applications, promote policies and communicate with customers. The New Zealand Government used Facebook to encourage responses to a policy consultation whilst the Irish Government used YouTube to release videos providing information on budget changes.

4.91 As these technologies develop and use of social media becomes more widespread this has the potential to be a useful tool more efficient tax administration.

4.92 The UK has increased the use of online returns and payments for personal income taxes – around 77% of personal income tax returns were filled online in 2011. However in the area of corporate income tax a low proportion use online returns – 42% in 2011 compared to 100% in the Netherlands.

Conclusions

4.93 Large variations exist internationally in the tax systems used by different countries. However there are general trends exhibited globally of movements towards general consumption taxes and base broadening more generally (allowing lower tax rates than may otherwise be the case).

4.94 Beneath the high level trends, there are also examples of specific reforms which often prove challenging to implement. Scotland can learn from the lessons – such as the importance of timing, the transition of changes, considering the effects of change at the overall level, and the benefit of independent experts and extensive consultation.

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87 OECD Tax Administration 2013
5. Responsibilities and Opportunities

Chapter Summary

- Chapter 5 sets out a range of choices, opportunities and responsibilities that an independent Scotland would face in designing a tax system.

- Independence would provide a significant increase in the fiscal and economic responsibilities of the Scottish Government and Scottish Parliament.

- It would provide an opportunity to examine the tax system as whole, and design a framework based on specific Scottish circumstances and needs.

- In addition, there would be scope to take advantage of the opportunity to design a more robust and efficient tax system than is currently in place in the UK. If successful this would give Scotland a significant competitive advantage.

- A number of challenges and responsibilities would also emerge however. These include the transition to independence and operating close to a large economic neighbour into which there is a highly integrated single market.

- Just like any other country, Scotland would face certain responsibilities and constraints, both technical and practical, which will influence the scope and design of its tax system.

Introduction

5.1 Under independence, Scotland would be responsible for setting, administering and collecting all its revenues.

5.2 This would be a step-change from the current framework.

5.3 Under independence, Scotland would be responsible for choosing a set of taxes to achieve growth and employment, to deliver a desired amount of revenues, and also establishing an administrative and institutional framework to ensure that taxes due are paid and collected in an effective manner.
5 Responsibilities and Opportunities

5.4 Post-independence, Scotland would have a unique opportunity to design and implement a tax system which was based on key principles – simplicity, stability, neutrality and flexibility – and was designed to the appropriate scale whilst reflecting the distinct characteristics and preferences of Scottish society and the local economy.

5.5 At the same time, a number of key challenges would exist. For example, Scotland would be required to ensure that the tax system played an effective role in supporting the overall macroeconomic framework and delivering a stable level of public services. There will be a need to use elements of the existing UK tax system while a modern Scottish system is under development. A clear direction of travel for transition between the two tax systems will therefore be important, including establishing the priority order in which key Scottish taxes will be developed and implemented.

5.6 Any consideration of a new Scottish tax system should also take account of the economic linkages with the rest of the UK and the importance of the ease of paying taxes, not just within Scotland, but across the highly integrated economic area of Scotland and the UK (and increasingly Europe).

5.7 The Working Group’s recommendations for fiscal policy included in the First Report are set out in Box 5.01.

**Box 5.01 - Fiscal framework recommendations**

The Scottish Government should look to establish a fiscal framework – including the use of fiscal rules and an independent fiscal commission – which maximises economic policy flexibility and provides opportunities to promote economic growth, deliver greater economic resilience and address inequalities in Scotland.

**Recommendation**: the framework should focus on long-term sustainability through effective management of the public finances alongside ensuring growth, economic policy flexibility and creating opportunities.

**Recommendation**: the Scottish Government should seek, in principle, to establish a stabilisation fund such as an Oil Fund, to help manage its natural resources and to enhance future economic resilience.
5.8 Taxation has a number of important roles -

- Fundamentally, it is integral to the macroeconomic framework and the socio-economic model of a country.

- It is essential in raising the required revenues to ensure the stability, sustainability and predictability of public finances and for the provision of public goods and services.

- Alongside welfare policy it can influence the distribution of income and economic opportunity in an economy.

- It impacts directly and indirectly on economic activity and behaviour, which is important for correcting market failures and meeting environmental and wider government objectives.

5.9 In this chapter, we discuss some of the challenges and opportunities that Scotland would face post-independence.

5.10 Ultimately the tax system of a country reflects, and helps shape, the socio-economic model which the country wishes to pursue. Individual taxes may differ in their progressiveness, impact on the environment or their relationship with economic growth. However, it is important to focus on the system as a whole, rather than particular taxes in isolation.

5.11 This is particularly important in tax design and reform, where there are often ‘losers’ and ‘winners’ from individual measures. These ‘winners’ and ‘losers’ could be compensated or made to contribute. If the changes lead to efficiency improvements, potentially everyone could become better off while the relative distribution of resources remained the same.

**Challenges and opportunities**

5.12 Scotland, as with all countries, has unique features and attributes.

5.13 It is a modern, advanced open economy with strong social and economic links to a large neighbouring market (the rUK), and also has access to the 500 million consumers of the EU.
5 Responsibilities and Opportunities

5.14 In this chapter, a number of inter-related challenges and opportunities are discussed. Each is important for the debate on an optimal tax structure for an independent Scotland –

- Designing a modern tax system
- Delivering an effective macroeconomic framework
- Promoting competitiveness, economic growth and tackling inequalities
- Implementation and transition
- The European and international context

Designing a modern tax system

5.15 As highlighted throughout the report, independence would require Scotland to design its own tax system.

5.16 One obvious option would be to continue with the existing UK system, but simply implement it in Scotland.

5.17 This would be a missed opportunity. The UK system has a number of weaknesses that could be reformed, relatively easily, should Scotland become independent.

5.18 Moreover, Scotland has a population of over 5 million, compared to the UK’s over 60 million. Aside from different aspirations and economic structures, this differential makes it unlikely that simply implementing the UK system would be optimal for Scotland. Instead, Scotland’s relative scale provides an opportunity to align government and regulatory functions in a more comprehensive and streamlined manner. The design, administration and operation of a more focused and simple tax system could sit inside such a framework.

5.19 As highlighted in Chapter 4, many countries of a comparable size to Scotland have taken a proactive role in designing an efficient tax system. The Scottish Government should therefore look to the experiences of other countries to ascertain best practice and to apply these, where possible, to the Scottish context.
5.20 As part of this, the Working Group believes that a future Scottish Government should establish a tax policy forum with international and industry experts to help inform the design and implementation of a given tax policy. Scotland has an international reputation for tax specialists and academic expertise, and using this to help inform the practical implementation of tax policy would be advantageous.

**Box 5.02 - Industry and expert engagement**

The Scottish Government has recently established a Tax Consultation Forum to facilitate engagement with taxpayers and expert communities. Chaired by the Finance Secretary, it provides the opportunity for contributions from representative bodies, networks and organisations with an interest in the tax system.

This is a welcome initiative and something that is likely to be successful, if designed correctly, in a country of Scotland’s size.

The Fiscal Commission Working Group believes that any move to greater autonomy in Scotland should be accompanied by the extension of the remit of this forum. This would ensure that any contribution from experts and sharing of their knowledge can have the maximum impact.

Parliament and the Scottish Government would retain the key decision making powers in setting the overall objectives of the tax system, including the required revenues and distribution of the burden of tax, and the final judgement on the deployment of the system. However, such a forum could ensure that once decisions were made, how a tax policy was introduced and administered would be as efficient and transparent as possible.

The Working Group believes that in setting up a new tax system in the first place, a wide forum should be convened – involving trade unions, employer organisations, business leaders, policy makers, tax specialists, academics and other interested groups – to debate and design a framework that is in Scotland’s interests.

This approach has the potential to build more confidence and credibility in the system, and if it improves the perceived integrity of the tax system may lead to higher compliance and lower administration costs. Vital to this is designing such a forum to lean against any vested interests, ensuring undue influence is not exerted by those with the loudest voice.
5 Responsibilities and Opportunities

Box 5.03 - Different tax choices for Scotland

As set out earlier in the paper, there are a range of specific options which Scotland could consider in the design of its tax system. Scotland could choose to move its tax system towards models seen internationally which have clear objectives and which exhibit relatively low administration costs. A select few examples to consider and debate further could include –

**Designing a modern tax system**

- Development of General Anti-Avoidance Rule and working with international partners to ensure cross-border businesses pay their fair share of tax.

- Use of modern technology and techniques to lower the burden of administration and compliance – such as an ‘online first’ approach to tax returns, the possibility of using pre-filled tax returns as used in countries such as Denmark, and use of unique identifiers.

- Alignment of income and social security contributions (i.e. same bandings and periods) could aid transparency and computability – while potentially increasing the progressiveness of the system.

- Better linkages and streamlining of institutions involved in i) setting tax policy, ii) implementing tax policy, iii) administering tax collection, iv) linking to business policy, v) linking to welfare policy and vi) linking to environmental policy.

**Delivering an effective macroeconomic framework**

- Broadening the tax base by reviewing the appropriateness of different tax reliefs, allowances and deductions – which have created a complex landscape which is prone to loopholes and avoidance – whilst compensating any people affected by unintended consequences through better targeted fiscal policies. All else equal, broadening the tax base would allow lower overall tax rates and total revenues to remain equal.

- Creating a Scottish Stabilisation Fund to provide greater certainty and stability in tax and expenditure planning, see Box 5.04.

- Explore options for commonality in measurement of certain elements of the tax base across Sterling Zone for key mobile tax bases (e.g. corporate) to reduce compliance and administrative burdens, deliver fairness and ensure appropriate levels of tax are paid.
- **Encourage savings and investment** with Scottish tax free savings products and explore other international examples of the treatment of investment and wealth income.

**Promoting competitiveness, economic growth and tackling inequality**

- A **competitive policy of taxation** targeted both at the overall ease of doing business, supporting employment and the development in key sectors could spur real economic investment and counter the agglomerative pull of London and South East of England.

- The **overall competitive mix** – including the use of a select few targeted tax reliefs – has the potential to reduce burden on firms - increasing investment, employment and economic growth – and allowing focused support on key growth sectors.

- Adjust tax policies to address key challenges which might not be an issue at the central level. For example, the Working Group notes the Scottish Government’s concerns about **limitations on Scotland’s connectivity** – which drives both business investment decisions and tourism. This includes the rates of Air Passenger Duty which may not reflect the capacity and utilisation of Scottish airports.

- **Linking the tax and welfare systems** to ensure the system can be used to tackle inequality effectively and efficiently. This paper has set out the importance of considering tax and welfare together in the design and operation of the entire system.

**The European and international context**

- The Working Group is also struck by the growing debate around the introduction of a minimum level of tax - to help ensure that taxes which are due are collected. Scotland could work with like-minded countries to explore the options for implementing a system in which businesses and high net worth individuals paid their fair share. One way to do so is to use average tax rates weighted by activity or employment levels.

5.21 As identified in the previous chapter, tax reform is often challenging to enact – particularly fundamental reforms based on introducing greater principles into the system, as with the UK, or to broaden the tax base (Irish Universal Social Charge or the Australian Minerals Resource Rent Tax).
5 Responsibilities and Opportunities

5.22 However, independence would provide Scotland with a unique opportunity to undertake such reform – and it is important that the intentions and principles of the Scottish Government and Parliament were set out clearly and early.

5.23 The establishment of a tax forum, comprising of independent experts, would bring credibility into the design of the new system, and a continuing open and consultative engagement with industry, employee and employer groups, and other stakeholders, to review the effectiveness of tax policy would be welcome.

Delivering an effective macroeconomic framework

5.24 The Working Groups proposals for a robust macroeconomic framework have been based around two overarching objectives of long-term competitiveness and short-run responsiveness.

- **long-term competitiveness** – maximising opportunities to raise productivity, competitiveness, economic security and resilience over the long term; and

- **short-run responsiveness** – maximising opportunities to respond swiftly and effectively to changes in circumstances.

5.25 Fiscal policy is a key element of the macroeconomic framework, even more so in a monetary union.

5.26 The tax system should be designed to ensure that the levels of borrowing and overall public sector debt are manageable and sustainable.

5.27 To ensure stable and sustainable tax receipts, providing credibility to Scottish fiscal policy, the Scottish Government could:

- Identify options to broaden and diversify the tax base through sustainable economic growth – and consider the options a broader tax base would permit – i.e. lower rates or higher expenditure;

- Establish a ‘Scottish Stabilisation Mechanism’ to manage the revenues from offshore production;
• Establish a Fiscal Commission which provides oversight on government finances, fiscal projections and monitors fiscal rules.

5.28 The tax system should be designed to ensure that levels of borrowing and overall public sector debt are manageable and sustainable but that there is also sufficient flexibility – both in-built via automatic stabilisers and through allowing for discretionary action – to respond effectively in times of economic difficulty.

5.29 The sustainability and predictability of tax receipts requires a sufficiently broad tax base and a diverse range of activities being taxed. This is not just about the tax system, but also about the structure of the wider economy. As set out in Chapter 10 of the Working Group’s first report, boosting the strength, diversity and resilience of the Scottish economy should be a key objective of any new independent government.

5.30 As highlighted in the previous chapter, with respect to tax policy, broader tax bases would present Scotland with a number of options; tax rates could be reduced while raising the same levels of overall revenue, or the increased revenue could be used for public expenditure, or a mixture of the two. Such choices would be subject to the sovereign Scottish Parliament, and should be taken while considering the entire system.

5.31 The dangers of narrowing the tax base too much were highlighted in the previous chapter with illustration to Ireland. Broadening the tax base may be more difficult in benign or expanding economic situations – as reforms which create winners or losers in certain areas are politically challenging – but the situation is often exacerbated if sudden changes are required as a result of a macroeconomic shock.

5.32 Another area of particular importance for Scotland is the management of tax receipts from the offshore oil and gas industry.

5.33 Scotland is energy rich, both in hydrocarbons and renewable energy. It is estimated that receipts from offshore oil and gas production would have averaged around 17%88 of total Scottish revenues over the past 5 years. Managing this resource will be an important objective for an independent Scottish Government.

88 Government Expenditure and Revenues Scotland, Scottish Government
5 Responsibilities and Opportunities

5.34 Box 5.04 highlights the potential of a Scottish Stabilisation Fund to ensure that public finances are not unduly exposed to movements in the revenues from oil and gas.

**Box 5.04 - Scottish Stabilisation & Savings Fund**

As outlined in the second report of the Working Group, there is clear merit in establishing a stabilisation fund, providing a liquid source of funding to help support the Scottish public finances and economy if needed. This would also ensure any higher than expected receipts are saved rather than being used to fund current expenditure.

This approach would help ensure predictability in the budget process and in the setting of policies and spending programmes.

An attractive approach in the short-term would be to develop the government’s spending plans on the basis of a cautious forecast of oil revenues. Then, if oil revenues exceed the forecasts, the excess can be transferred into a stabilisation fund.

Such an approach would ensure that the public finances were not unduly exposed to movements in oil revenues. It would also ensure that transfers into the oil fund did not come at the expense of planned funding for current public services.

Alongside this, the establishment of a long-term savings fund would also allow the benefits of oil and gas extraction to be shared across future generations.

5.35 Alongside a stabilisation fund and savings fund, the Working Group has also recommended that Scotland should look to establish an independent fiscal commission and fiscal rules which can help maximise the effective management of the public finances.

5.36 A report on this institution will also be provided in a subsequent Working Group publication.
Box 5.05 - Tax Variation in a Monetary Union

It has been argued by some that a monetary union necessarily implies full tax harmonisation.

From an economic perspective, this is not the case. Indeed, and as the Working Group’s first report outlined, fiscal autonomy within a monetary union is important as it allows policy variation to address and take advantage of local challenges and opportunities which otherwise would not be possible with a common monetary policy. It is therefore vital to the success of a monetary union.

What is necessary however, is an overarching agreement covering levels of borrowing and debt. Within this tax flexibility is vital.

This is the case in the Euro Area and, where there are no plans for full tax harmonisation.

Indeed, the European Commission has stated there is no need for an across the board harmonisation of Member States’ tax systems. Provided that they respect EU rules, Member States are free to choose the tax systems that they consider most appropriate and according to their preferences.

The spokesperson for the EU Taxation and Customs Commissioner has recently confirmed this position, stating there are “no plans for any proposal to harmonise rates, as this is an issue of national sovereignty”.

The Belgium-Luxembourg Economic Union - established in 1922 – provides an interesting case study.

Within the economic union, the Belgian Franc accounted for the larger share of the monetary supply and was widely used in both countries. Luxembourg did issue its own currency, the Luxembourg Franc, but it was only used within Luxembourg itself.

Flexibility existed within the union for the countries to introduce distinct tax regimes, and accommodate two economies with differing structures.

From 1980 to 2002, when the currency arrangement came to an end, the top marginal rate of tax on corporations was consistently between 5 and 10 percentage points lower in Luxembourg than in Belgium.

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89 http://ec.europa.eu/taxation_customs/taxation/gen_info/tax_policy/
This flexibility has continued now that the two countries have adopted the Euro. Luxembourg currently has in place a standard VAT rate of 15%, the lowest amount permissible within the EU, whereas Belgium’s standard VAT rate, at 21%, is around the EU average.

**Promoting competitiveness, economic growth and tackling inequalities**

5.37 The design of a tax system ultimately reflects the society people aspire to build. Tax policy decisions imply tough choices about economic and social preferences, including the distribution of income and wealth across society and the provision of public goods and services.

5.38 As seen in the previous chapter, there are large variations internationally in the scale of taxation, and the type and structure of taxes used by countries.

5.39 Ultimately, taxation policy stems from these objectives, both in terms of the level of revenues required to fund the desired amount of public expenditure and choices around issues such as the progressiveness of the tax system.
5.40 Post-independence, these fundamental choices will fall to the Scottish Government and Scottish Parliament.

5.41 In the first report, the Working Group highlighted that although the overall structure of the Scottish economy is broadly similar to the UK, there are differences, particularly when looking within sectors and the business stock.

5.42 Scotland for instance has a higher share of Government and Other Services (25.7% vs 23.3%) and a lower share of Business Services and Finance (25.4% vs. 29.1%)

5.43 Within sectors the differences between the two economies become more apparent – including the importance of the oil and gas industry in Scotland – both offshore and the onshore supply chain – and the relatively high proportion of total UK activity in diverse sectors from fishing to life insurance.

5.44 Scotland also has a relatively smaller business base, low start-up rate, and lower levels of business expenditure on research and development. The significance of large companies in the Scottish economy is also greater than for the UK as a whole though headquarter functions of these firms is more limited in Scotland.

5.45 At the same time, there is also some evidence to suggest that the Scottish population maintains distinct social preferences and values, including views on equality, sustainability and the role of the public sector.

5.46 Such differences are highlighted in the findings of the Scottish and British Social Attitudes Surveys. For instance, a higher proportion of people in Scotland agree (or agree strongly) that the government should redistribute income and that the government should spend more on welfare benefits for the poor, see Table 5.01.
Table 5.01 – Social attitudes to welfare and redistribution, Scotland and England & Wales

<table>
<thead>
<tr>
<th>Statement</th>
<th>The government should spend more on welfare benefits for the poor</th>
<th>The government should redistribute income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Scotland</td>
<td>England &amp; Wales</td>
</tr>
<tr>
<td>Agree strongly (%)</td>
<td>5.6</td>
<td>4.3</td>
</tr>
<tr>
<td>Agree (%)</td>
<td>33.1</td>
<td>26.2</td>
</tr>
<tr>
<td>Neither Agree nor Disagree (%)</td>
<td>25.7</td>
<td>31.7</td>
</tr>
<tr>
<td>Disagree (%)</td>
<td>29.4</td>
<td>32.1</td>
</tr>
<tr>
<td>Disagree Strongly (%)</td>
<td>6.3</td>
<td>5.7</td>
</tr>
</tbody>
</table>

Source: British Social Attitudes Survey 2010, Scottish Social Attitudes Survey 2010

5.47 Therefore, prior to decisions regarding individual taxes, Scotland would have the opportunity to consider the high level balance and mix of taxes. Such choices should reflect the objectives of the tax system, the distinct circumstances of Scotland, along with the practical and technical constraints, while embedding the principles of a simple and effective tax system.

Competitiveness, growth and industrial policy

5.48 A key element of this will be deciding how to use the tax system to encourage economic growth.

5.49 As highlighted earlier, effective tax systems which place low compliance burdens on business, encourage participation in the labour force, boost investment (both physical and human capital) and assist the economically efficient production of goods can create an environment which enables economic growth and welfare gains.

5.50 Specific challenges, and areas of comparative advantage, can also be targeted by the tax regime.

5.51 Moreover, as all governments use taxation to fund public services, the actual collection and administration of taxation presents opportunities for countries to optimise their tax system to create an internationally competitive environment. This can often work against the desire to design a tax system with specific allowances and support on economic grounds.

5.52 So there is therefore an important balance to be struck between the flexibility of the tax system for meeting objectives beyond revenue raising, against the benefits of simplicity.
Governments attempt to use tax policy to deliver on a range of economic objectives, including encouraging trade and investment; supporting entrepreneurship and business growth; supporting the development of growth sectors; encouraging innovation etc.

The tax system could be used to aid the delivery of each of these aspects. For example:

- **Business Taxes** can influence investment decisions by firms – domestic and Foreign Direct Investment – the business models developed and the structure of the business base.

- **Tax credits** can be targeted to encourage investment in specific activities – for example, export tax credits can incentivise some firms (for example, SMEs) to export; whilst R&D tax credits are designed to encourage firms to invest in higher levels of innovative activity (which could have spill-over effects for the whole economy);

- **Personal Tax Rates** relative to competitor economies can influence the location decisions of workers – in particular, mobile skilled labour. Limited levels of skilled labour could constrain the growth of certain sectors. Income tax rates may also impact on the skills and training decisions of workers (for example, higher taxes could reduce the overall net return to an individual); and

- **The complexity of tax rules and tax compliance costs** will influence the ease of doing business, and are an important consideration for businesses alongside the regulatory regime. For example, high compliance costs and complex tax rules could act as a barrier to entrepreneurs starting up new businesses, or prevent overseas firms from investing in the economy.

- **The interactions between personal taxation and welfare** if not set correctly can discourage or inhibit employment growth. In contrast, a well-designed system can not only boost employment incentives but help create meaningful and well rewarded employment. This can help tackle poverty and inequalities and create a fairer society.

Along with the design characteristics of particular taxes – in the form of tax incentives and rates - key drivers of economic growth are affected more generally by the level of taxes that are raised, the mixture of taxes used, the quality of tax administration, and the certainty, predictability and computability of tax liabilities.

The tax system is one part of the competitiveness policy mix. In most instances, a mixture of policy levers will be used to influence growth and improve performance. For instance, the effectiveness of R&D tax credits will depend crucially on an appropriately skilled workforce and strong links between business and universities.
5 Responsibilities and Opportunities

5.53 A simple tax system – for instance with minimal allowances, reliefs and exemptions – may in itself facilitate economic growth through reducing the administrative and compliance burden on business and households and providing clarity and certainty about tax implications.

5.54 However, certain opportunities and challenges – such as encouraging innovation and savings, and wider social and equality objectives – may require specific reliefs and allowances which move the system away from an entirely uniform system.

5.55 The Working Group believes that an optimal system will allow for a degree of flexibility – including addressing evolving economic, political and social circumstances – but focus on maintaining a simple and uncomplicated system.

5.56 Key economic priorities should be identified for Scotland, and then consideration given to how best to vary certain elements within the system to achieve these outcomes.

5.57 Targeted policy interventions should only be provided through a sound and well-motivated framework which considers the costs and benefits – and in many cases be time limited or transitional with regular reviews to confirm they still meet their original objectives. This will maintain the focus on keeping a clear and principles based approach.

Equality

5.58 The tax structure is important not just for economic policy but also wider social policy, which is in turn a determinant of economic output.

5.59 Despite continued economic growth and improving labour market conditions, there is evidence that income inequality has widened over the past 35 years in the UK. Indeed, 2011 OECD research found that since 1975 income inequality among working-age people increased more quickly in the UK than in any other OECD country.\(^91\)

5.60 Access to the relevant policy levers of taxation and welfare policy would provide more opportunities for the Scottish Government and Scottish Parliament to address these trends.

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5.61 Earlier sections of this report have highlighted the importance of aligning taxation and welfare policy. Under the present system, individuals can be both taxpayers and recipients of benefits. In a fully integrated system, ‘negative income taxes’ could provide an alternative method of taxing and redistributing income. The primary characteristic of such a system is that income would be assessed and if it fell above a certain level the individual (or household) would be subject to taxation, however if it fell below a certain threshold then the income would be supplemented by transfers.

5.62 Such a system would allow the theoretical benefits of lump sum taxation\textsuperscript{92} to be used in practice without the unfairness associated when these are for tax liabilities rather than transfers.

**Sustainability**

5.63 Scotland is developing towards a low carbon economy, with legally binding commitments on the emissions of harmful greenhouse gas. Along with environmental considerations, this also provides the opportunity for Scotland to benefit from supply side developments and position itself as a leader in new technology (e.g. in renewables).

5.64 Full control of taxation would provide the Scottish Government with the choice as to whether to take advantage of the responsibility for ‘green’ taxes, investment of redistributive policies to reflect this focus on low carbon technology.

5.65 More generally, Scotland will have an opportunity to exploit its position and scale to fully integrate its tax system into its wider economic and social policies. Not just being a scaled down version of a large country, Scotland could create a coherent environment supporting skills, infrastructure, openness, regulation and law, alongside taxation, to ultimately drive forward sustainable economic growth and ensure the spoils are shared fairly across the population.

5.66 This is particularly true for focusing on the growth sectors of the Scottish economy - sectors which offer particular opportunities for growth due to existing comparative advantages or through the potential to capitalise on Scotland’s natural assets.

5.67 Opportunities would also exist to tie in taxation and expenditure to a wider policy of sustainability policies. For example, there has been much debate about encouraging community

\textsuperscript{92} Lump sum taxation results is economically efficient as it does not alter incentives at the margins
benefits – where local residents capture the gains from the benefits of nearby developments such as renewable schemes and have the potential to invest in such operations.

Implementation and transition

5.68 Implementing a new tax system will require a careful transition.

5.69 An independent Scotland would inherit the UK tax code and framework. Consideration should be given to the transition process, and the scope for initial variation in tax design – both from day one of independence and in the years immediately following independence.

5.70 Getting the transition period correct is vital to both ensuring that revenues are collected by both governments and minimising the impact of any change on businesses and individuals.

5.71 Early engagement with the UK Government, and HMRC in particular, on issues of tax collection would be to the benefit of both countries. The Scottish Government and HMRC have worked closely in preparing for the implementation of the Scotland Act 2012, and early engagement on broader issues could build on this consultative relationship.

5.72 In the medium to long term, choices exist between establishing a largely or wholly new system and retaining elements of the existing UK model. Such choices should reflect the objectives of taxation in Scotland, and recognise a system based on the principles of simplicity, neutrality, stability and flexibility is best placed to meet these objectives.

5.73 Potential changes should be assessed on the basis of their impact on decisions made under the previous tax regime (including if transition arrangements should be put in place to allow legitimate expectations to be upheld) and with consideration to the compliance of individuals and businesses which have accounting and payroll systems designed on the current UK tax system.

5.74 Costs (including administrative and compliance) should be minimised through careful planning and consideration prior to and during the transition period. Any such costs should be outweighed by the long term benefits of reforms to the system.
5.75 The Working Group would recommend exploring opportunities for short-term service level agreements between the tax authorities in the two countries to provide for the gradual transfer of administrative responsibilities over a transitional period.

5.76 The UK will remain a key partner for a future independent Scottish economy, and therefore any design of a new tax structure should take into consideration future interactions with the UK market and what this may mean for wider economic policy.

5.77 The design of the Scottish tax system should therefore not be considered in isolation, especially with respect to the rest of the UK (but also increasingly Europe and further afield).

5.78 This may influence policy decisions. For example, if a tax policy was to encourage/discourage migration between different parts of the UK or transfer pricing or ‘cross-border’ shopping.

5.79 Defining and measuring certain elements of the tax base across the Sterling Zone for certain mobile taxes could make sense. It could reduce the burden on businesses, lower administration costs, and protect revenues. Importantly, such a system would allow the rates and policies to widen or narrow the base to be set independently and differently across both Scotland and the UK.

5.80 Another example might be in sectors where there are close interactions and changes in the tax system may have a significant impact. For example, many financial products are constructed on the basis of a particular tax system.

The European and international context

5.81 Independence will clearly take place within a broader international context. This includes both Scotland’s relationship with the European Union and further afield.

5.82 European Union rules on taxation will for example constrain, to some extent, the scope of changes available to an independent Scotland. Box 5.07 highlights taxation in the EU context, including limits on the minimum level of VAT rates across member states, and that a share of VAT is hypothecated to the EU budget.
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5.83 Across the EU, the average standard rate of VAT is 21 per cent, 6 percentage points higher than the minimum standard rate allowable. Internationally, there is an increasing trend in the use and rates of general consumption taxes.

5.84 Categories of goods and services which can be charged at a reduced rate of VAT are also specified in EU directives. Member states have retained exemptions for certain goods and services which were in place prior to the standardisation of VAT rates, or have negotiated exemptions during accession negotiations.

5.85 Scotland would be required to meet its obligations in respect to the rates of VAT charged, and other European rules on taxation (i.e. excise taxes). Retaining the exemptions that Scotland currently has, as a member of the EU through the UK, would appear to be a sensible starting point and maintain continuity.

5.86 With full representation at the EU institutions, Scotland would also be in a position to make the case for particular policies which, while perhaps not significant at the UK level, were in its own interest.

5.87 Of course, the UK is also subject to the same European and international tax requirements, so although they may constrain, to an extent, the design of a Scottish tax system, this is equally true for tax reforms by the UK Parliament and other EU member states.

Box 5.07 - Tax Rules within the EU

The European Commission tax policy strategy sets out an approach that aims to eliminate barriers to cross border economic activity. The European Commission makes clear that this does not imply full scale tax harmonisation, but that a large degree of harmonisation and cooperation is required in areas such as Value Added Tax (VAT) and excise duties given their impact on relative prices between EU member states.

Countries within the EU are required to have in place minimum standard VAT rate of 15%. As of January 2013, the range of standard VAT rates in place across the EU was between 15-27%. Excise

duties, which cover alcohol, tobacco and energy products, are generally subject to higher minimum tariffs.

There are, however, exemptions which allow some member states to apply a zero-rate of VAT to some goods. The UK, for example, applies a zero-rate to a number of products, meaning that the final price to the consumer does not include VAT, and that the VAT on any inputs is also deducted\textsuperscript{96}.

When goods are traded across an EU border, the seller is permitted to deduct the input VAT on goods destined for another member state, the buyer must then pay VAT in the destination country. This eliminates any advantage that a firm in another member state may have over a firm in a different member state arising from VAT rate differences between the two countries.

When a firm in a member state imports goods from out with the EU, VAT will be paid in the member state into which the goods are imported\textsuperscript{97}.

Currently, VAT is charged on a destination based system, where the final VAT rate is determined by the location of the buyer. It is the proposal of the European Commission that the EU move towards an origin based system, where the rate of VAT on final products is determined by the location of the supplier. However, there are a number of barriers to achieving this given that VAT rates still differ substantially between member states, and the fact that there is no consensus as to how receipts can be distributed under an origin based system to represent actual consumption patterns.

5.88 An independent Scotland would require to continue double taxation treaties with international partners to ensure credibility and certainty in the Scottish tax system and to facilitate international trade, investment and to protect the integrity of the Scottish tax base.

5.89 The Working Group expects that international tax treaties would remain in force between Scotland and third party states that have signed tax treaties with the UK.

5.90 Tax treaties provide reciprocal benefits, and therefore the expectation is that it would be in all parties’ interests to facilitate the smooth transition and continuation of existing international

\textsuperscript{95} Luxembourg has the lowest standard VAT rate in Europe of 15%, Hungary has the highest at 27%, for more information on VAT rates in the EU, see http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_en.pdf

\textsuperscript{96} For a full list of VAT exempt products in the UK, see http://www.hmrc.gov.uk/vat/forms-rates/rates/goods-services.htm#1

\textsuperscript{97} If the goods are transported through the transit procedure into another member state on arrival then the VAT must be paid in the member state in which the transit process ends.
5 Responsibilities and Opportunities

agreements. This is in the spirit of increased international cooperation on tax affairs – spearheaded by the OECD with its ‘Global Forum on Transparency and Exchange of Information for Tax Purposes’, and work on the automatic exchange of information and Base Erosion and Profit Shifting (BEPS)\(^98\).

5.91 In the case of Czechoslovakia, international tax treaties in place between Czechoslovakia and other countries, for example the UK, prior to Czechoslovakia’s dissolution on 1 January 1993, were inherited by both the Czech Republic and Slovakia thereafter and continued in place. This succession to treaty obligations by the Czech Republic and Slovakia was accepted by other countries – including the UK.

5.92 In the first instance, the double taxation treaties that Scotland will inherit should be taken as given, and as such, the tax system should be designed around these to maximise returns from the existing framework.

5.93 Scotland and the rest of the UK would of course have to reach bilateral agreements around the treatment of taxes for cross border businesses and individuals. This is unlikely to be difficult.

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**Box 5.08 - Double Taxation Treaties**

Double taxation treaties are agreements between two or more states, which are put in place to protect against the risk of the same income being taxed more than once by different countries, enhance certainty in the treatment of taxable income to facilitate international trade, and protect the integrity of the signatory countries tax systems against tax evasion and discriminatory treatment of domestic businesses operating internationally.

The United Kingdom has over 100 double taxation treaties\(^99\), forming one of the largest networks of tax agreements in the world. World-wide, there are more than 2,500 such treaties, and organisations such as the OECD help synchronise the development of the treaties and provide model agreements\(^100\) which are often used as a starting point when two countries work together to establish tax agreements.

Under the current constitutional arrangements, international negotiations on taxation are reserved

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\(^99\) [http://www.hmrc.gov.uk/taxtreaties/dta.htm](http://www.hmrc.gov.uk/taxtreaties/dta.htm)

\(^100\) Model Tax Convention on Income and on Capital 2010, OECD, 2012
to the United Kingdom, and the double taxation treaties of the UK will include the treatment of the Scottish tax base and the interests of Scots living abroad, and Scottish companies operating abroad.

The work being undertaken already to identify Scottish taxpayers as part of the implementation of the Scottish Rate of Income Tax would make the process of identifying the separate tax bases less complex in the event of independence.

Globalisation and modern supply chains

5.94 In the modern global economy, many companies operate internationally, with operations and supply chains spanning multiple national borders. This presents a challenge as to how national governments can ensure that they capture their ‘correct’ share of taxes.

5.95 For instance, the micro-electronics industry which was at its peak in Scotland in the early years of the 21st century did not contribute significant tax revenues in the UK. Operating on a cost-plus basis, components were assembled in Scotland but then exported to be sold elsewhere and only marginal profits were attributed to the Scottish section of the supply chain.

5.96 In the design of a Scottish tax system, it will be important to look at how taxes in the supply chain – and the use of transfer pricing – is occurring internationally, and to identify systems to ensure that appropriate taxes are being paid to authorities across the supply chain.

5.97 As such, in considering a system which collects a reflective share of business taxation, it is important to look beyond issues such as the headline corporation tax rates, and examine the use of measures of value-added, economic activity, environmental damage etc to identify appropriate levels of taxation.

5.98 The significant expansion in e-commerce – with internet sales and increase in online services – presents a particular area which needs to be considered closely as it has the potential to distort traditional economic activity.
5 Responsibilities and Opportunities

Conclusions

5.99 Scotland would have the opportunity to design a new tax system built around Scottish circumstances and preferences.

5.100 Scotland would need to build skills and capacity over a transition period, supported by, in all likelihood, the use of short-term shared service agreements for instance. It would have the opportunity to communicate clearly and early the direction of travel it intended to move – and the principles it would base the system on.

5.101 The Scottish Government would be able to build upon the capacity and lessons learnt from the implementation of the tax powers in the Scotland Act 2012 to assist with the transition and implementation of new powers.

5.102 As shown internationally, a clear and principles based approach does not require that all tax reliefs should be abolished – neither is it optimal to do so. Reliefs and incentives which encourage innovation, R&D, investment in skills and training, and savings for instance have a valuable role to play. Most importantly, Scotland would be in a position to choose what was appropriate, based on its own objectives and preferences. A key focus should however be on simplicity.

5.103 Taxation is a key lever in competitiveness, economic growth and tackling inequalities. Appropriate tax rates maximise overall tax receipts by creating the optimal level of economic activity in both the private and public sectors. The appropriate rates and structures of key economic taxes - including corporation tax, national insurance contributions, VAT, capital gains tax and Air Passenger Duty - would be the responsibility of the Scottish Government and Scottish Parliament following independence.

5.104 The overall competitiveness of the economy goes beyond the tax system, and Scotland would have the opportunity to take advantage of its scale and position to align all its economic policies – such as labour force, skills, regulations, infrastructure and welfare policy – towards creating an environment of sustainable economic growth.

5.105 Independence will take place in the wider context of European and international agreements and practical restrictions. Scotland would need to meet all its obligations, but would be no more subject to such restrictions than the rest of the UK.
5.106 Taxation plays a key role in a robust and successful macroeconomic framework. Scotland would have the ability to vary its underlying taxes and government spending in a monetary union with the rest of the UK, something that would be essential to allowing cyclical adjustments and smoothing in the absence of separate monetary policies.

5.107 The design and implementation of a Scottish tax system should, where possible, be underpinned by the credibility and expertise which comes with an independent tax forum and an open and consultative approach to reviewing the effectiveness of tax policy.

5.108 In the chapter that follows the Working Group sets out in more detail specific recommendations for Scottish Ministers which encapsulates the discussions in this report. We trust that such recommendations will be of interest to all sides in the constitutional debate.
5 Responsibilities and Opportunities
6. Conclusions and Recommendations

6.1 In February 2013, the Working Group set out its proposals for a credible and robust macroeconomic framework for an independent Scotland.

6.2 Taxation lies at the heart of such a framework. Our first report made recommendations regarding the fiscal framework and economic levers, including:

- the framework should focus on long-term sustainability through effective management of the public finances alongside ensuring growth, flexibility of economic policy and creating opportunities.

- the Scottish Government should take forward a programme of work to scope out and design an efficient and cost effective tax system.

6.3 To facilitate the Scottish Government’s work in this area, this paper has set out the role of taxation, the principles of a simple and effective tax system and some of the key opportunities, choices and responsibilities that an independent Scotland would face.

Role of taxation

6.4 As this work has indicated, taxation has a number of important roles -

- Fundamentally, it is integral to the macroeconomic framework and the socio-economic model of a country.

- It is essential in raising the required revenues to ensure the stability and sustainability of public finances and for the provision of public goods and services.

- Alongside welfare policy it can influence the distribution of wealth and economic opportunity.

- It can be an important tool for enhancing growth, diversification of the production base and competitiveness in the economy.

- It impacts directly and indirectly on economic activity and behaviour, which is important for correcting market failures, discouraging the consumption of de-merit
6 Summary and Recommendations

goods (i.e. tobacco) and environmentally damaging behaviours, along with promoting wider government objectives such as stabilising the macroeconomic environment.

6.5 With independence, Scotland would assume full responsibility for revenue raising and taxation policy. Independence would present the Scottish Government and Scottish Parliament with the powers to determine what taxes to implement, at what rates and the structure of these taxes in terms of the bandings, allowances and reliefs.

6.6 This would -

• Provide full accountability to the Scottish Parliament in raising revenue and public expenditure. The benefits of good (and costs of bad) policy making would be fully retained in Scotland.

• Allow the full envelope of taxation, fiscal policy, and other economic levers, to be used in a coherent approach to maximise the environment for economic growth, sustainability and tackling inequalities and risk sharing in public finances.

Socio-economic vision

6.7 Taxation ultimately reflects, and helps shape, the socio-economic model which the country wishes to pursue. The provision of public goods and services is funded by the revenues raised through taxation. The desired role and size of the public sector is therefore integral to such discussions.

6.8 Alongside welfare, taxation is the main means for the redistribution of income and wealth and is also important in supporting efforts to reduce inequality and boost economic opportunities.

6.9 Individual taxes may differ in their progressiveness, but analysis of equity implications should focus on the system as a whole, rather than particular taxes in isolation. For example, people often confuse a ‘broad tax base’ with a less equal one. This is not the case.

6.10 This is particularly important in tax design and reform, where there are often opportunities to compensate ‘losers’ from one change through altering other parts of the fiscal system. If the
changes lead to efficiency improvements, potentially everybody could become better off while the relative distribution of resources remained the same.

6.11 Taxation can incentivise behaviour and be designed to reward or encourage different activity, such as employment, enterprise and innovation, saving and investment.

**Macroeconomic framework**

6.12 Taxation is an important tool for management of the economy - influencing economic cycles through managing demand – and it is a key component of fiscal aggregates such as overall spending parameters and debt levels.

6.13 In a monetary union with the rest of the UK, fiscal policy and taxation will play an important role in both promoting broad cyclical alignment whilst at the same time providing opportunities to address long-term differences, weaknesses and challenges, and take advantage of economic opportunities.

**Competitiveness**

6.14 Taxation can be both a source of competitive advantage or disadvantage. Competitiveness of the tax system can be thought of both in terms of levels (e.g. rates on mobile international capital and domestic factors of production) and in terms of the burden that the administration of the tax system places on businesses.

6.15 The international nature of modern business and the competitiveness of a country should be taken in the wider context of the business and economic environment. The burden of taxation and the administrative compliance costs form only one factor in the overall costs and ease of undertaking business in an economy.

6.16 It is crucial that moves to improve competitiveness are aimed at attracting genuine economic activity which feeds into improvements in the real economy and leads to employment.
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**Principles of a simple and efficient tax system**

6.17 As set out earlier, the Mirrlees Review found that in formulating the objectives of a tax system, for a given distributional outcome, what matters is:

- the negative effects of the tax system on welfare and economic efficiency – they should be minimised;
- administration and compliance costs – all things equal, a system that costs less to operate is preferable;
- fairness other than in the distributional sense – for example, fairness of procedure, avoidance of discrimination, and fairness with respect to legitimate expectations;
- transparency – a tax system that people can understand is preferable to one that taxes by ‘stealth’.

6.18 A tax system which is simple, neutral, stable and flexible is best placed to meet these objectives.

6.19 A simple tax system is one in which tax rules and obligations are well known, easily understood, and liability is clear. With a simple tax system, taxpayers will be able to anticipate in advance and factor into their decision making, with minimal burden and uncertainty, the tax consequences of an action.

6.20 Neutrality is important in minimising the negative or unintended effects of taxation – such as on labour supply decisions and the allocation of resources – but does not imply that the tax system should not be utilised to influence behaviours, especially where welfare and efficiency can be improved via taxes.

6.21 The behavioural effects of taxation are not uniform across the population, with individuals, for example, responding differently to changes in taxation. As highlighted earlier in the paper, the interactions between the tax and benefit system are particularly important in driving behavioural responses, particularly for certain groups who are at the labour force participation margin.
6.22 This leads to a trade-off between the benefits from designing a tax system in a more tailored manner against the simplicity – and consequential lower operational costs – of a ‘one-size fits all’ system.

6.23 The stability of the tax system can be considered in two related ways – the stability of revenues which governments raise through taxation, and the stability of tax rules which face individuals and businesses.

6.24 To ensure a clear and principles based approach to the design and operation of the tax system, a decision framework using a robust analytical approach should be used to balance policies in terms of their long term costs and benefits and to check that the stated objectives are being met in the most efficient way.

**Issues for an independent Scotland**

6.25 Clear and early communication from the Scottish authorities of its intentions and plans will allow for adequate consultation and implementation. Setting out the intended direction of travel for the design of the tax system will help ensure credibility and understanding.

6.26 Special attention should be given to the taxation of oil and gas extraction given it represents a significant share of Scottish tax revenues and, along with the associated supply chain, is an important sector of the Scottish economy. Investment decisions in oil and gas production are based on long term time horizons, increasing the importance of a stable and computable tax regime.

6.27 Diversification and broadening of the tax base will also increase the stability and certainty of tax revenues, with the potential to lower the exposure of variation in a concentrated number of sources of taxation.

6.28 As part of the Working Group’s proposals for retaining Sterling and establishing a monetary union with rest of the UK, agreement would need to be reached on the fiscal aspects of such an agreement. Such agreement should only be in terms of the overall fiscal potion (i.e. net debt and borrowing), and allow for flexibility in regards to the underlying taxes and design of the system.
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Opportunities and Constraints

*Design a system tailored to Scottish characteristics, with focus on delivering economic growth and sustainability.*

6.29 Scotland, as with all countries, has unique features and attributes. It is a modern, advanced open economy with strong social and economic links to a comparatively large neighbouring state and the European Union.

6.30 Scottish independence would provide the opportunity to examine the tax system as whole, and design a system based on specific Scottish circumstances and needs which was focused on meeting the objectives of a successful tax system.

Mobility of capital and labour

6.31 Highlighted across this paper, in modern open economies the design of national tax systems can no longer afford to consider domestic tax policies in isolation. The increasingly globalised nature of the world economy means that tax bases have become greatly more mobile, both inwards and outwards, as labour, and especially capital, can move more freely between countries.

6.32 Under the present constitutional arrangements, combating tax avoidance and evasion is a matter reserved to the UK. Under the limited tax powers available under the Scotland Act 2012, Scotland has already consulted on its approach to tax avoidance, including a General Anti-Avoidance Rule (GAAR)\(^{101}\).

6.33 International action and agreement is essential to tackling tax avoidance by multinational corporations. An independent Scotland would have to be mindful of this and develop appropriate processes and policies. Scotland would have the opportunity to use its voice and influence to promote such agreements.

*European Union rules, double taxation treaties, and fiscal sustainability agreement with rUK*

6.34 Scotland would need to meet its obligations with regards to European Union rules on taxation, particularly concerning VAT.

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101 A Consultation on Tax Management, [http://www.scotland.gov.uk/Publications/2012/12/5404](http://www.scotland.gov.uk/Publications/2012/12/5404)
6.35 The Working Group expects that international tax treaties would continue in force between Scotland and third party states that have signed tax treaties with the UK.

6.36 An agreement between Scotland and the rest of the UK on the taxation of individuals and businesses which work and operate across both countries would be particularly important to prevent double taxation, to maintain certainty in the implications of cross-border trade, and to ensure the correct revenues are collected by both authorities.

6.37 Tax treaties provide reciprocal benefits, and therefore the expectation is that it would be in all parties’ interests to facilitate the smooth transition and continuation of existing international agreements.
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**Recommendations**

**Designing a modern tax system**

- A **Scottish system should be clear and principles based** – any exemptions and tax reliefs should be carefully targeted.

- The government should set out and develop a transparent **framework for policy making** – based around clearly defined objectives and principles of a good system, with decisions based on a robust and analytical assessment of costs and benefits.

- A Scottish system should be built to ensure that there is a **whole view approach to consumer and business taxation** – including the use of unique identifiers to aid simplicity, transparency and compliance.

- Scotland should look to have an efficient **government structure and institutional landscape** to maximise the effectiveness and efficiency of tax policy design and tax collection and links with wider socio-economic policies.

6.38 Independence would provide Scotland with the opportunity to design the tax system with the 21st century in mind – focusing on stability and certainty, and considering the international aspects of the modern global economy at the very heart of the design and thinking.

6.39 Independence would provide an opportunity to examine the tax system as whole, and design a system based on specific Scottish circumstances, preferences and needs which was focused on meeting the objectives of a successful tax system.

6.40 The advice of the Fiscal Commission Working Group would be to aim for a simple and broad approach to taxation in the long-run, and consider carefully areas where there were clear economic or social reasons for targeted policy. If implemented this could be a major competitive advantage for Scotland.

6.41 The interaction of the tax and welfare systems should also be considered, especially in regards to its impact on incentives to work and improving the transparency of the system.
6.42 When designing a new tax system, the Scottish Government should consider the key principles of simplicity, neutrality, stability and flexibility in the design of a tax system for an independent Scotland. Such a system would reduce the administrative and compliance costs to both the exchequer and households and business, improve the integrity of the system, and reduce economic inefficiencies.

6.43 The use of single tax identifiers is not only useful in easing administration and maximising compliance, but also provides a stream of data and information which has the potential to provide important performance indicators and allow feedback into policy design.

6.44 Streamlined institutions could greatly simplify the administrative framework of taxation in Scotland. The current UK system has a number of large institutions operating in the domain of tax policy and administration.

6.45 For instance, HM Treasury, HM Revenue and Customs, the Department for Work and Pensions, and other Whitehall departments for individual taxes (such as DECC for energy, DEFRA for environmental taxation etc), all hold a stake in the design and operation of the tax system. While Scotland will require its own institutions, it could take advantage of its scale and the opportunity presented by independence to create a focused and streamlined landscape designed to maximise the ease of designing and implementing tax policy. Again, the success of the administration, decision making and monitoring of the tax system will crucially depend on the simplicity of the system as a whole.

6.46 The Scottish Government should look to international examples of modern and efficient tax systems, which minimise administration and compliance costs. An aspiration for administration costs in the top quartile of OECD members would focus the design of the system on efficient and modern collection technologies.

6.47 The Scottish tax base needs to be sufficiently broad, and the wider economy sufficiently diversified, to prevent macroeconomic shocks from hindering the collection of sufficient revenues – a danger associated with narrowing tax bases. The creation of a more diversified economy will take time, but should be a clear objective of future policy making.
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Delivering an effective macroeconomic framework

- The Scottish Government should **consider tax policy design as part of the wider fiscal and macroeconomic framework**, including the use of fiscal rules and the establishment of an independent fiscal commission.

- **High levels of integrity and transparency** should be brought to the system through the establishment of a **tax policy forum** – using independent experts would ensure that vested interests did not unduly influence the design.

6.48 The design of national tax policy cannot be considered in isolation. This is especially important in the context of the proposed macroeconomic framework.

6.49 In designing a tax system, the Scottish Government should focus on ensuring the stability of revenues to enable consistent expenditure planning. A broad tax base and the use of a Scottish Stabilisation Fund will limit the impact of variable oil and gas revenues in particular. The Fiscal Commission Working Group set out the rational and options for incorporating a Stabilisation Fund into Scotland’s fiscal framework.

6.50 The Scottish Government should consider the long term sustainability of tax revenues and design a credible system which will respond to changing economic and social circumstances.
Promoting competitiveness, economic growth and tackling inequalities

- The Scottish Government should design a tax system built around **Scottish circumstances and preferences to help increase productivity and economic growth** while meeting the needs of the people of Scotland.

- **The tax and welfare systems are key levers for tackling inequality** – both are strongly interlinked and should be considered as fundamentally part of the same system. Welfare and tax policy should therefore be developed in tandem to ensure policy integration and alignment.

- Appropriate tax rates maximise receipts by creating the optimal level of economic activity and revenue raising potential. The Scottish Government **should assess the optimal balance of tax rates and bases for key taxes**, such as business and employee taxes, and levels of government spending.

- **An open and consultative approach** with the industry, independent experts, employer groups, and the general public, should be adopted when designing and reviewing the effectiveness of tax administrative policy to ensure the system is comprehensive, inclusive and maximises compliance.

6.51 Whilst corporation tax forms one part of the overall competitiveness mix of the Scottish economy, other reforms should also be considered – particularly those with additional employment and skills-based consequences.

6.52 As outlined above, the advice of the Working Group is to, where possible, put forward a simple and transparent approach to taxation. However, there are clearly instances where a targeted approach is both desirable and optimal (both economically and socially). Therefore, the Scottish Government should balance the trade-off between simplicity and flexibility of the tax system. It should consider a framework which focuses on a small selection of areas where tax could be used to pursue such objectives while maintaining as broad a tax base as possible. The UK, with near 1,000 tax reliefs, is far too complex and inefficient.
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6.53 A broad tax base will provide a stable base to facilitate economic growth, while it also presents options for lowering overall tax rates while still collecting the same level of revenues – creating a competitive business environment.

Transition and implementation

- The Scottish Government should **build upon the experiences and lessons from the implementation of the tax powers in the Scotland Act 2012** to assist with the transition and implementation of further new powers.

- The government should **focus on identifying key priorities** and consider what can practically be achieved by the following milestones:
  - Independence day;
  - The short run (e.g. initial 5 years following independence);
  - Medium to long run (e.g. beyond 5 years).

- The Scottish Government should build up skills and capacity over a carefully planned **transition period** – but should also communicate clearly and early on the direction of travel it intends to take.

6.54 An independent Scotland would inherit the UK tax system. This will constrain the spectrum of opportunities to immediately change the tax system in Scotland from that it inherits. This is a similar conclusion to that of the Scottish Government’s Expert Working Group on Welfare. Prior to day one of independence, the Scottish Government would have the opportunity to review the complexities, exemptions and anomalies in the current UK system, and identify whether some of these could be practically changed on the first day of independence, and what could be achieved thereafter.

6.55 There should be early review of this legacy system an early discussion about the balance of taxes that Scotland would have in its tax system. Clearly establishing a position on the direction of the tax system would avoid creating uncertainties.
6.56 During the early transition period, Scotland would have the opportunity to alter taxes at the margin (e.g. different tax rates, thresholds) as well as immediately take certain taxes fully into its own jurisdiction.

6.57 All changes should be considered in the context of the decision making framework outlined in this paper – focused around the costs and benefits to the entire system and based around the objectives of the policy and the principles of a good tax system.

6.58 Such considerations should extend to areas where benefits may arise from maintaining a degree of alignment with the UK tax system – at least in the short-run - and balancing these against the costs from doing so.

6.59 The Scottish Government should consider how to manage changes to the tax system in Scotland which impact on decisions based on the current UK regime. This is particularly important for activity and investment decisions in the North Sea, which are based on long return horizons and reflects the significance of the oil and gas sector to the Scottish economy.

6.60 The Scottish Government should continue to extensively engage and consult with industry experts and academics. The Scottish Government should consider establishing a group of such stakeholders to assist with the technical design of the Scottish tax system, based on the stated objectives of the Scottish Government and Scottish Parliament.
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The European and international context

- The government should put the **issue of globalisation at the heart of its tax system** - including how to tax modern multinational companies and considering how best to collect tax in a world of international supply chains and e-commerce. International agreement is critical to ensuring companies pay the appropriate level of taxation and the government should work with key international partners to ensure the fair collection of taxes due.

- As part of this, the government should also use any new influence to **support international bodies** – including the EU and OECD – in their drive for greater tax cooperation, transparency and collection.

- The government should liaise with other governments, including the UK, around **defining and measuring core elements of the tax system**, including what constitutes taxable income. This could minimise compliance burden, ensure fairness and avoid inefficient shifting of activities for tax purposes, particularly across the Sterling Zone. Crucially, tax rates, thresholds, and allowances would remain the domain of the separate jurisdictions.

6.61 The Scottish tax system must be considered against the European Union and wider international implications.

6.62 The Working Group recognises the problems with tax avoidance, and the on-going international work to ensure that companies pay their fair share of taxation.

6.63 Modern international corporations operate across multiple national borders, and use complex structures and supply chains in the production of final goods and services. Tax systems are often not designed to cope with these modern commercial practices – and as such an independent Scotland would have the opportunity to put solving this issue at the heart of its tax system.

6.64 Part of this would be identifying how, where and on what basis companies are paying taxation and considering if this is a fair reflection of the amount due in Scotland or if it is capturing its appropriate share of revenues.

6.65 Small and medium sized firms are the engine of growth. To minimise the burden of tax compliance on small firms, reduce administration costs, and facilitate trade across the countries, the
government should consider the potential definition and measurement of common core elements of the tax system.

6.66 An independent Scotland should seek to use its voice and influence to shape international developments and agreements in such areas.

Summary

6.67 With independence, Scotland would be required to design and operate its own tax system. This will be challenging, but also provide opportunities.

6.68 In this paper, the Working Group has set out the principles of a modern and efficient tax system which should be followed in meeting the objectives of the tax system in the most efficient manner.

6.69 Although this work is focused on taxation, it is crucial that a system-wide approach is taken across the design of tax, welfare, public expenditure, and macroeconomic stability. The Working Group has set out a framework on this basis, for which changes and decisions should be considered within – including analysis of the costs and benefits and use of reviews and time limited concessions.

6.70 The scope for a radical departure from the UK tax system on day one of independence will be shaped by practical considerations such as the need to continue to raise revenue for public services. A transition period will be required. In line with our recommendations for a whole system approach, and particularly the integration between the tax and the welfare system, this transition should align with that set out by the Expert Working Group on Welfare as far as possible.

6.71 Over the intermediate years there will be an opportunity for full consideration of the appropriate tax system for Scotland and its objectives.

6.72 Independence provides the opportunity to debate the optimal design of the Scottish taxation (and welfare) systems over the coming years, engaging with industry, trade unions and the general public.
6 Summary and Recommendations

6.73 Independence would provide a unique opportunity to develop a modern and efficient tax system. If Scotland was to get it right, it could be used as a powerful tool to grow key areas of the economy and tackle longstanding weaknesses. An efficient system could be a major international competitive advantage for Scotland supporting more investment, jobs and growth.

6.74 Establishing such a system will be challenging and should be phased over time. However, the benefits of moving to such a system will undoubtedly pay off in the long-run.
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