Submission from Adrian Sinfield

Response to the Scottish Finance Committee call for evidence

A Scottish Approach to Taxation

Professor Emeritus of Social Policy,
University of Edinburgh

- *How can the Scottish Government's four principles to underpin Scottish taxation policy best be achieved?*
- *To what extent do the mechanisms for administering the Scottish income tax system via HMRC limit the scope for a different tax system in Scotland to develop?*

- Principle 1: Be proportionate to the ability to pay

Summary: The HMRC tax system does not enable the ability to pay to be measured with any confidence. Very many reliefs and other arrangements are not properly taken into account so that the extent of redistribution upwards is concealed. The Scottish government will not be able to effectively operate a tax system that is proportionate to the ability to pay until full account is taken of this problem.

The first principle set out by the Scottish government for taxation policy is that it should: 'Be proportionate to the ability to pay'. Unfortunately, however, the present UK tax system does not enable us to decide whether it is in fact operating by this principle. Indeed there are strong grounds for concluding that it is not.

The current operation of the UK system with multiple reliefs, subsidies and other arrangements conceals much of its redistributive effects. In consequence, it is far from providing a system that enables us to say whether Adam Smith would consider the system proportionate to the ability to pay. Smith not only made a clear case for progressive taxes: 'It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion'. He also emphasised the importance of contribution in return for 'enjoy[ing] the protection of the state' (Smith (1776) 1996, Article I, pp 324 and 307)).

Much is made by politicians and the media of the large proportion of income tax paid by the top few per cent of taxpayers, but there is much less attention paid to the total incidence of taxes. However, the UK government's own analysis of the effect of taxes and benefits on household income (ETBHI) has reported this annually for very many years. The latest official figures show that in 2014-15 the average proportion of gross household income paid in all taxes was 33.8%. The top fifth paid 34.4% while the bottom, poorest, fifth paid 37.4% (ONS, 2016). So the UK total tax system appears basically proportional with a tendency to the regressive rather than the progressive. This pattern has not been very different for many years and is hardly appropriate for the principle ‘proportionate to the ability to pay’.

A major reason for this lack of progressivity is the heavy use of a wide range of tax and National Insurance contribution reliefs. For example, the net UK cost of non-state pensions tax relief is estimated to be £21 billion, while another £11 billion goes in relief on employer NI contributions to approved pensions. Capital gains taxes are not included in the ETBHI but the estimated cost of the non-taxation of gains arising from the disposal of one’s only or main residence is £18 billion (HMRC, 2015).

It might be argued that the very purpose of these reliefs is to adjust taxable income proportionate to the ability to pay. In some instances this may well be so but it is highly questionable whether this is the general picture. All the available evidence show that the benefits from reliefs such as these go predominantly to the better-off, and to those with the highest incomes most of all. In consequence, Stanley Surrey, the American tax lawyer who introduced the idea of tax expenditures, described them as ‘upside-down’ benefits (Surrey, 1973, p 37): they go more to those with more income and fewer needs in conventional social policy terms and so are not proportionate to the ability to pay – a form of what might be called reverse targeting, if not perverse.

However, no regular official analyses are published, or even apparently provided internally, to reveal this redistributive effect. The only rare analyses of current reliefs have been of the distribution of pension contributions in response to occasional parliamentary questions. The latest showed that in 2014-15 some three-fifths of the estimated cost of the relief went to those paying above the basic rate of income tax, or who would be if that relief did not bring them below that threshold (Hansard, 2014). It should be added that this did not take into account who benefits from the tax relief on investment income to pension funds.

The Institute for Fiscal Studies (IFS) has carried out one detailed analysis for the UK that allowed an estimate of the total impact of reliefs. By these reliefs the top ten per cent of taxpayers reduced their 2004-05 tax bill by nearly £12 billion over and above the basic personal allowance - some 70% of that extra tax relief identified in the study. The top one-tenth of the top one per cent – some 47,000 people - were estimated to benefit annually by nearly £50,000 each. With a pre-tax income 31 times the average, they gained from tax reliefs 86 times the average, enabling those at the very top to ‘race away’ from the rest of us even further and at considerable public cost (my estimates from Brewer et al, 2008, Table 1. I do not believe that a breakdown of this analysis for Scotland is available.)

The need to take fuller account of the operation of tax and related reliefs and similar arrangements has been further underlined by work by the Office for Tax Simplification (OTS) (2011) and the National Audit Office (NAO) (2014 a and b). Their reports have revealed and discussed the implications of the fact that there are far more tax reliefs than regularly listed by HMRC – currently over 1100 for all taxes while HMRC only lists some 400, and the number continues to rise. The total cost is unknown as HMRC only estimates the cost for barely 200, less than a fifth of the total. While maybe half of the larger total are technical tax arrangements, half have social and/or economic purposes that result in some people or bodies being better off than others. Some may have small costs but others could add considerably to the total loss through reliefs.

The OTS and NAO have opened up issues of power and control that parliamentary select committees, particularly the Public Accounts Committee (PAC), are now at last pursuing (Sinfield, 2016). 'HMRC … continues to avoid publishing information on the scale and nature of tax reliefs that would assist Parliamentary oversight of this area of the tax system' (PAC, 2015, summary). Although there has been some improvement in the data made available, the full comment by Amyas Morse, the Comptroller and Auditor-General of the NAO, at the release of the NAO report, *The effective management of tax reliefs,* (NAO, 2014b) is still very relevant:

'HM Treasury and HMRC do not keep track of tax reliefs intended to change behaviour, or adequately report to Parliament or the public on whether tax reliefs are expensive or work as expected. We found some examples where HMRC and HM Treasury proactively monitored and evaluated tax reliefs, but in general the Departments do not test whether their aims for the reliefs are being achieved. Until they monitor the use and impact of tax reliefs, and act promptly to analyse increases in their costs, HMRC and the Treasury's administration of tax reliefs cannot be value for money' (21 November 2014).

The ETBHI report regularly provides a figure showing the proportion of taxes paid and benefits received by different quintiles (ONS, 2016, figure 3). If it were to include the benefits gained from tax reliefs in the proportion of income received in income, the pattern would be very different from the downward redistribution currently shown. It would also lead to a different picture in section 4 which at present shows that 37% of the non-retired households and 88% of the retired received more in benefits than they paid in taxes.

It should also be noted that, over and above specific reliefs, salary sacrifice arrangements do not appear in HMRC cost statistics. Apparently no evidence has yet been collected that enables HMRC to estimate their cost, despite indications that many more companies are making increasing use of them. It would appear, for example, that virtually all pre-1992 universities provide salary sacrifice arrangements by default for staff with USS pensions at a significant saving on NI contributions. The UK government is currently consulting on the operation of salary sacrifice but it has already indicated that its proposals will not apply to arrangements for employer-provided pensions, employer-supported child care and workplace nurseries and the cycle-to-work scheme which allow tax as well as NI contribution reductions. These generally benefit the better-off more than those at or below median earnings thus increasing inequality. At the very least their cost and distributive effect should be identified. At present in policy discussions they are not even mentioned – in, for example, recent government consultations on pensions tax relief.

The case for reform was set out very clearly nearly a hundred years ago by Lilian Knowles, the solitary woman on the 1920 Royal Commission on the Income Tax. Reader in Economic History at the University of London, she insisted on a formal Reservation from the majority view for expanding tax reliefs for children to all taxpayers:

> 'The Income Tax should not, in my opinion, be worked as an engine of social policy by which to carry out hidden bounties. The bounty should be given … where it can be seen, where its cost can be estimated directly, and in a form in which people realize what they are getting' (Knowles, 1920, p 159).

Having to operate the Scottish tax system via the current HMRC one with this extent of reliefs and other arrangements will seriously constrain the creation of a fair and effective system that is proportionate to the ability to pay. This problem must be both openly acknowledged and every effort made to overcome it.

References:

Brewer, Mike, Sibieta, Luke and Wren-Lewis, Liam (2008) *Racing away? Income inequality and the evolution of high incomes*, Institute for Fiscal Studies, IFS Briefing Note no. 76 - www.ifs.org.uk

Hansard (2014) Written Answer to PQ from Steve Doughty, 10 December.

HMRC (2015) *Tax expenditures, reliefs and ready reckoners statistics* https://www.gov.uk/government/collections/tax-expenditures-and-ready-reckoners

HMRC (2016) *Consultation on salary sacrifice for the provision of benefits in kind*, London: HMRC.

Knowles, Lilian (1920) *Report of the Royal Commission on the Income Tax*, London: HMSO, Cmd 615.

NAO (2014a) *Tax reliefs*, HC 1256, SESSION 2013-14, 7 April 2014

NAO (2014b) *The effective management of tax reliefs*, HC 785, SESSION 2014-15, 7 November 2014.

ONS (2016) *The effects of taxes and benefits on household income: Financial year ending 2015*, Office for National Statistics.

OTS - Office of Tax Simplification (2011) *Review of tax reliefs: final report*, London: OTS, March.

PAC - Public Accounts Committee, *HMRC's performance in 2014-15,* HC 393, Sept 2015, and evidence, para 141 on.

Sinfield, Adrian (2016) 'Tax benefits and their impact on the social division of welfare', *Fiscal welfare in Europe* workshop, Paris, May. http://fiscalwelfare.eu/wp-content/uploads/2016/04/as-fw-rev-to-Paris-5.16.pdf

Smith, Adam (1776, 1966) *The Wealth of Nations*, London: Dent.

Surrey, Stanley (1973) *Pathways to Tax Reform: The Concept of Tax Expenditures*, Cambridge: Harvard University Press.