Written Submissions on the Scottish Government Budget 2019-20

Contents

Written submission from Audit Scotland

Scottish Parliament Finance and Constitution Committee

Written submission by Audit Scotland on fiscal risks and the Scottish budget

Introduction

1. Understanding the opportunities and risks inherent in the operation of the Fiscal Framework, and how these are being experienced and managed in practice, is critical to the effective oversight of the Scottish public finances. In September 2018 the Auditor General provided a brief overview of the main risks that are now affecting the Scottish budget in a written submission to the Finance and Constitution Committee. In October 2018, Audit Scotland published a briefing paper setting out in more detail how the components of the Fiscal Framework are working, including tax raising, borrowing and reserve powers. This outlined four main risks:
   - **Economic performance risk** – the extent to which Scotland's relative economic growth affects the budget available to pursue policy objectives
   - **Policy risk** – the extent to which policy choices in Scotland and at the UK level affect the Scottish budget
   - **Forecasting risk** – the extent to which differences between forecasts used to set budgets and actual outturns affect future years' budgets.
   - **Budget management risk** – the extent to which the Scottish Government can manage fiscal risks, ensuring that public spending programmes provide value for money, while remaining within authorised budgets and the limits in the Fiscal Framework.

2. A lot of moving parts now affect the Scottish budget. Each carries a degree of risk and uncertain financial impact. Where the effects offset one another, the overall impact may be limited. If the effects are predominantly in one direction, the aggregate effects may be significant and difficult to manage. Budget risk is often seen in solely negative terms, but over time there may be either downside or upside outcomes.

3. Following the publication of the 2019/20 UK and Scottish budgets, more information is known on how these risks are developing. This paper considers the risks to the Scottish budget in light of the Scottish Government's taxation proposals and other relevant factors.

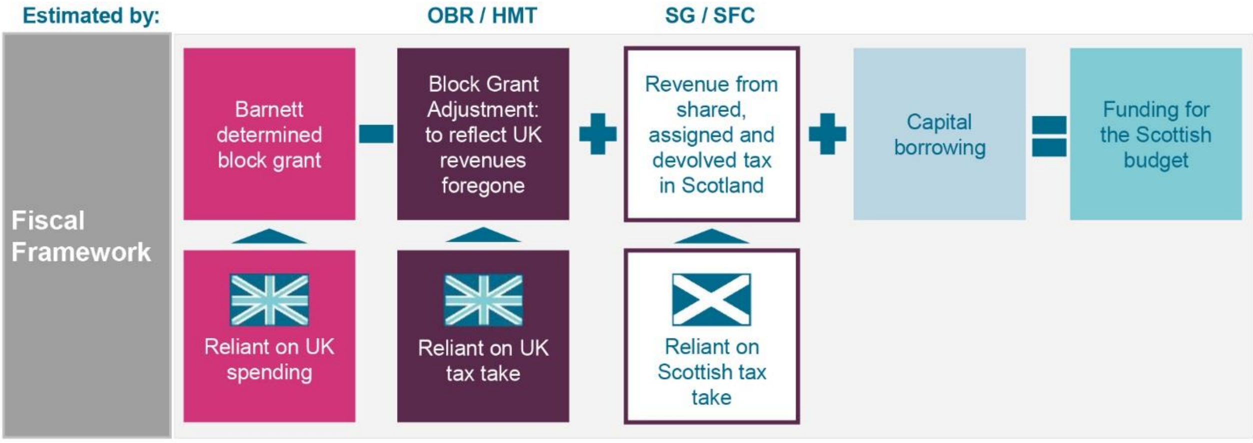
Economic performance risk

4. The Fiscal Framework is intended to incentivise the Scottish Government to increase economic growth. Increases or decreases in the Scottish budget are linked to

Scotland's economic performance *relative to* the economic performance of the rest of the UK (Exhibit 1), insofar as this affects the relative growth in tax receipts per head.

Exhibit 1

The relationship between Scottish performance and rest of the UK performance on the Scottish budget



Source: Audit Scotland

5. The Scottish economy has grown faster than the UK economy for the last two quarters. This recent GDP growth follows a more challenging period for the Scottish Economy.[1] Despite recent performance, forecasts of relative GDP growth present downside risks to the Scottish budget. The SFC states that while GDP growth has recently increased, average growth since 2010 remains low. It states that higher than expected growth in the last six quarters does not on its own provide compelling evidence to alter its longer-term outlook.[2]

6. As such, the SFC forecasts that GDP growth remains subdued over the longer term. This subdued growth, which is below forecast UK growth in both overall GDP and per person GDP growth terms, is primarily based on slow productivity growth. The Scottish Fiscal Commission summarises forecast GDP growth and GDP per person growth for the UK and Scotland as shown in Exhibit 2.

7. Relative GDP growth and other economic factors (including employment, earnings and productivity) are the key determinants of the tax revenues and associated BGAs included in the 2019/20 budget. The overall effect of tax forecasts in isolation, before taking into account Barnett consequentials and tax policy measures, is to reduce the amount available for the Scottish budget in 2019/20 and anticipated in subsequent years.

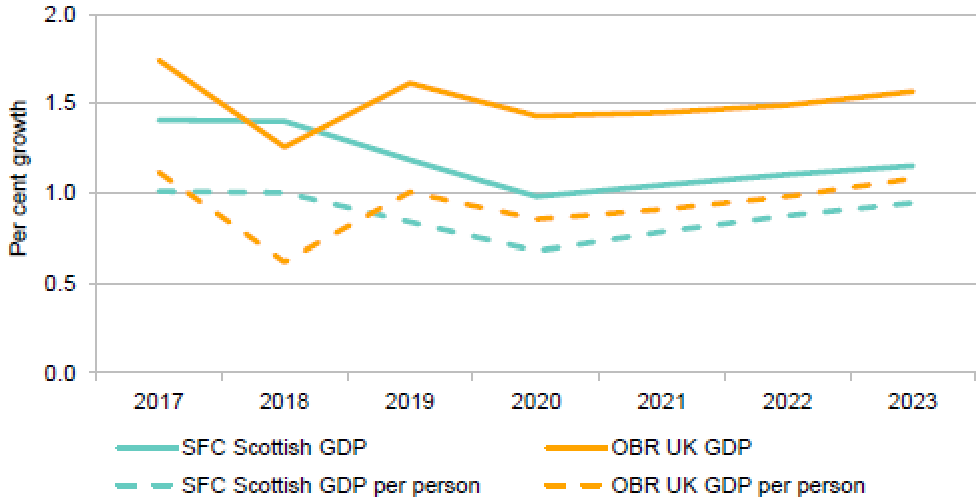
[1] Fraser of Allander Institute Economic Commentary, Vol 42 No 4, December 2018

[2] Scotland's Economic and Fiscal Forecasts December 2018, Scottish Fiscal Commission, December 2018

8. Actual growth in relative GDP and tax revenues in 2019/20 will not be known until after the end of the financial year. However, the SFC and OBR forecasts of relative economic and tax performance determine the amounts available in the 2019/20 budget.

Exhibit 2

The SFC forecasts for GDP growth over the medium term are lower than the rest of the UK growth forecasts



Source: Scottish Fiscal Commission

Policy risk

9. Different tax policy choices in Scotland compared to the rest of the UK can impact the Scottish Budget. Where the Scottish Government diverges from UK tax policy, available funding will increase or decrease by the forecast effect of this policy change on tax receipts.

10. Tax policy divergences in the Scottish budget for 2019/20 have resulted in a net increase to the Scottish budget. The main policy differences compared to the UK tax policy include freezing the higher rate threshold for Scottish Income Tax at £43,450; changes to additional dwelling supplement rates and non-residential LBTT; and differences in non-domestic poundage rates compared to the rest of the UK.

11. The SFC set out that, including policy divergence, the net effect of Scottish tax revenues and related block grant adjustments across each of the following five years has a positive impact on funding (Exhibit 3). This means that the net effect on the 2019/20 budget is to increase funding by £271 million, of which around two thirds relates to Scottish income tax. Forecasts suggest that Land and Buildings Transaction Tax net differences will contribute substantially to the positive total net difference, relative to the size of the tax.

Exhibit 3

Net position of tax forecasts and Scottish Government block grant adjustments

£ million		2019-20	2020-21	2021-22	2022-23	2023-24
Income Tax	SFC forecast	11,684	12,285	12,746	13,242	13,805
	BGA forecast	11,501	12,089	12,478	12,954	13,493
	Net difference	182	196	268	288	312
Land & Buildings Transaction Tax	SFC forecast	643	680	716	751	787
	BGA forecast	567	596	632	667	721
	Net difference	76	85	84	83	66
Scottish Landfill Tax	SFC forecast	104	83	13	13	14
	BGA forecast	91	83	81	74	62
	Net difference	13	0	-68	-61	-48
Total	SFC forecast	12,430	13,049	13,475	14,006	14,605
	BGA forecast	12,159	12,768	13,191	13,695	14,276
	Net difference	271	281	284	310	329

Source: Scottish Fiscal Commission

12. There are two ways in which policy changes have affected in the Scottish budget:

- **The SFC has adjusted its forecast assumptions for 2019/20 policy changes.** The SFC's forecast is adjusted for policy changes that were not known when earlier forecasts were made. For example, for Scottish income tax, the SFC had assumed in its May 2018 forecast for 2019/20 that the higher tax threshold would increase in line with inflation. Instead, Scottish income tax is proposed to be frozen at £43,450. The SFC has changed its forecast upward by £68.2 million to reflect the expected additional tax receipts resulting from this difference adding to policy effects carried forward from previous years. The overall effect on SFC forecasts of all new policies in the Scottish budget for 2019/20 changes is a net increase in forecast tax receipts of £65.2 million (Exhibit 4).

Exhibit 4

Tax policy changes in 2019/20 are forecast to result in increases to the Scottish budget

	£ million
Income tax	68.2
Non-domestic rates (net result of policy changes)	-41.6
Land and Building Transaction Tax	38.6
Overall effect of new policy proposals	**65.2**

Source: Scotland's Economic and Fiscal Forecasts December 2018 (Annex A), Scottish Fiscal Commission

- **The OBR block grant adjustment is based on UK policy for 2019/20.** The BGA shows the revenue forgone by the Treasury because of devolved taxation. This amount is based on the UK tax policy. If the Scottish Government does not match a tax decrease, it will benefit from a lower BGA while maintaining similar levels of tax receipts. For example, the Scottish Government states that if it had matched all UK Government income tax rates and bands, including a higher threshold of £50,000, it would cost the Scottish budget around £500 million in 2019/20.

13. The difference between the BGA and the SFC forecast of tax receipts is effectively added to or subtracted from the block grant. This increases or decreases the funding available. For Scottish Income tax, the net effect of the adjustments is to add £182 million to the block grant. This is different to the £500 million policy effect identified by the Scottish Government. This is because the OBR and SFC forecasts include other considerations for forecasted tax receipts, such as growth of the Scottish and UK economy, alongside tax policy. There are also differences in forecasting judgements and methodologies. Further detail of BGA calculations is needed to understand the extent of each of these factors.

14. There is a risk that changes in tax policy compared to the rest of the UK affect taxpayer behaviour. For 2019/20 the SFC has estimated that changed taxpayer behaviours arising from Scottish income tax divergence will reduce income tax by £13 million. This is due to change in taxpayer behaviour, such as reducing working hours, of £7 million and taxpayer residence behaviour of £6 million. This affects available funding. The Cabinet Secretary for Finance, Economy and Fair Work stated in his budget statement that he will ask the Scottish Government's Council of Economic Advisers to expand their analysis of the impact of potential behavioural effects and the possible impact on future revenues.

15. The SFC forecast for non-domestic rates revenue is £74 million lower than forecast in May 2018. NDR policy changes reduce the forecast by £41.6 million net. The downward revision also reflects data and modelling updates. The Scottish Government has discretion over the amount it plans to pay out from the NDR pool in any one year, so long as it maintains the pool in balance over time. In 2019/20 it proposes to distribute £2,853 million, £68 million more than forecast revenues. The SFC projects that this will mean a deficit of £100 million on the NDR pool at the end of 2019/20.

16. Anticipated additional revenue from policy divergence is dependent on the UK and Scottish tax policy remaining different. For example, if the UK Government changed its tax policy by lowering its higher tax threshold to match Scottish levels, any additional benefit from policy divergence would no longer apply, as the status quo will have been restored. This means that future UK tax policy choices could negate the additional revenues anticipated.

Forecasting risk

17. The Scottish Fiscal Commission (SFC) published tax forecasts to support the 2019/20 Scottish budget on 12 December 2018.[3] The Office of Budget Responsibility (OBR) published UK tax forecasts to support the UK level budget on 29 October 2018.[4]

18. These forecasts determine the amounts included in the 2019/20 budget proposals. Future Scottish budgets will ultimately be adjusted to reflect the difference between final outturns and original forecasts when the budget was set. This difference is referred to as forecast error. The Scottish Government must manage this forecast error through adjustments to future budgets. Larger forecast errors, which may be more likely in periods of greater economic uncertainty, will mean larger potential adjustments.

19. Outturn figures for fully devolved taxes (Scottish Landfill Tax and Land and Buildings Transaction Tax) are known quickly, either in year or shortly after year end. These taxes make up approximately two per cent of the fiscal resource budget, meaning that the forecasting risk attached to these remains minor for 2019/20. Forecast error relating to fully devolved taxes should be relatively straightforward to manage, predominantly through in-year budget management processes.

20. Scottish Income Tax accounts for a greater proportion of the budget and as such, smaller percentage variances between forecasted income and actual outturns could have a more significant impact on future budget adjustments. The first reconciliation adjustment for Scottish income tax is anticipated in 2020/21.

21. SFC and OBR forecasts provide updated forecasted outturns for 2017/18 and 2018/19, alongside forecasts to support the forthcoming 2019/20 budget. The 2017/18 Fiscal Framework Outturn Report showed that, based on the May 2018 forecasts, the 2020/21 budget would be reduced by £267 million to correct for Scottish Income Tax forecast error. This potential forecast error changes as more recent forecasts are produced, until the actual outturn is known. Based on the latest forecasts provided for the 2019/20 budget, the required adjustments to future budgets would be as follows:
    - The 2020/21 budget would be adjusted downwards by £145 million for 2017/18 forecast error (less than the adjustment based on the May 2018 forecasts)
    - The 2021/22 budget would be adjusted downwards by £472 million for 2018/19 forecast error.

22. The SFC note that based on 30 years of UK revenue forecasts, there has been an average absolute forecast error of 3.3 per cent. The SFC suggest that based on this for Scotland, it is not unreasonable to expect an average one-year ahead error in tax forecasts of around £530 million. This could be a positive or negative effect, with a similar potential error in the BGA forecasts. Critically the extent to

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[3] Scotland's Economic and Fiscal Forecasts December 2018, Scottish Fiscal Commission, December 2018
[4] Economic and Fiscal Outlook – October 2018, Office for Budget Responsibility, October 2018

which these errors affect future budgets will depend on whether they offset or amplify one another.

23. Both the UK and the Scottish budgets have been compiled during a period of significant economic uncertainty. The outcome of EU withdrawal is unknown and could affect both the UK and Scottish economy.

24. The Chancellor of the Exchequer, in his 2018 budget speech, said that if the economic or fiscal outlook changes materially in-year he reserved the right to upgrade the Spring Statement to a full fiscal event. Similarly, the Cabinet Secretary for Finance, Economy and Fair Work has stated that in the event of a no-deal Brexit, he may revisit the priorities of the 2019/20 budget. If this is done by way of a new budget for 2019/20, alongside a new UK budget, this would result in new economic forecasts, and potential changes in the budget available to spend in 2019/20. This would further inform the economic performance risks attached to the Scottish budget.

25. As noted above, there remains the possibility of a full fiscal event UK budget in spring, and a corresponding new Scottish budget. We noted in our October briefing that the extent of underlying uncertainty in the Scottish and UK economies increases the amount of forecasting risk.

Budget management risk

26. The Scottish Government has matched its planned spending for 2019/20 to anticipated sources of funding, including tax revenues, borrowing and the use of reserves within the provisions of the Fiscal Framework. Annex A of the budget document includes a reconciliation of available funding to spending.

27. Given the greater uncertainty and volatility currently attached to the Scottish and UK budgets, the Scottish Government will have to manage its financial position closely. This will include planning effectively for the changes that will impact on the budget across current and future years and responding to unexpected events. Budget management will involve smoothing out the consequences of this, including using the tools set out in the fiscal framework. These tools are not designed to insulate the Scottish budget from any structural differences in economic performance that continue over a number of years.

28. No resource borrowing has been anticipated in the 2019/20 budget. The SFC has projected that Scotland specific shock borrowing powers will not be available at any time over the five-year forecast horizon.

29. Proposed spending in 2019/20 includes £313 million funded from use of the Scotland Reserve, with the SFC also noting that £335 million is expected to be drawn from the reserve in 2018/19. The level of these drawdowns may change depending on the final level of underspend in 2018/19. A total of £538 million was retained in the Scotland Reserve at the start of 2018/19. We have previously highlighted the importance of the Scottish Government having a clear policy for how it will operate its reserve. The

potentially significant economic volatility which may materialise in future budget years emphasises the need for Scottish Government to be clear about how it would use reserves and other fiscal tools, such as borrowing powers, to mitigate any effects on the budget.

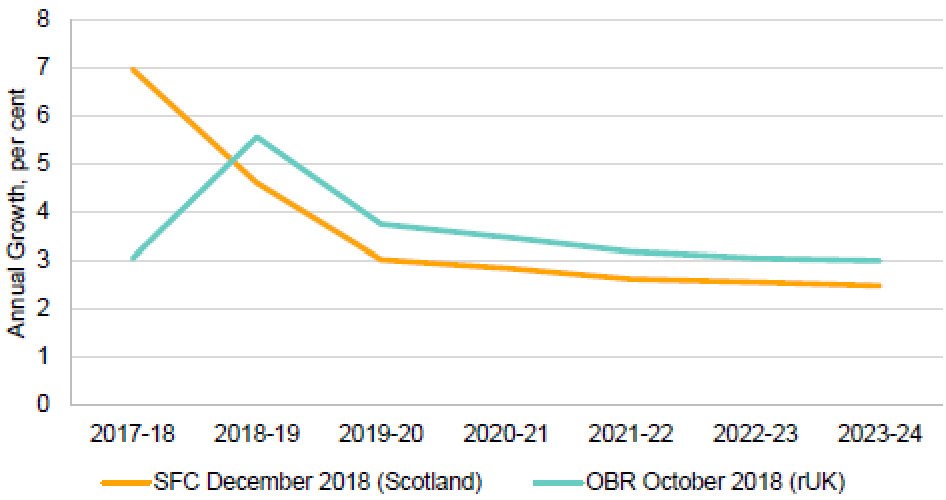
30. The Scottish Government will publish its updated medium term financial strategy in spring 2019. Understanding how medium-term volatility could affect spend on public services should include considering how projections have changed since the prior year's estimates. It should also be used to inform medium term planning, and to identify risks to disruption of service delivery.

31. The Scottish budget for 2020/21 is expected to include devolved VAT assignment for the first time, with forecast revenue of over £5 billion. The agreed assignment methodology for calculating Scottish VAT receipts has now been published with detailed work continuing.[5]

32. VAT assignment does not apply to the 2019/20 budget, but the SFC has produced illustrative tax forecasts for VAT (Exhibit 5). These indicate that VAT assigned to Scotland will grow less strongly than VAT raised in the rest of the UK. This is largely due to household consumption being expected to grow more slowly over the forecast period.

Exhibit 5

VAT assigned to Scotland compared to VAT raised in the rest of the UK



Source: Scottish Fiscal Commission

33. There is a risk that lower assigned VAT growth in Scotland will reduce the Scottish budget once VAT assignment is devolved. The Scottish Government will need to manage this risk and consider how this affects the overall budget and spending priorities over the medium term.

[5] Scottish VAT assignment: Summary of the Assignment Model, Her Majesty's Treasury, November 2018

Written submission from Chartered Institute of Taxation (CIOT)

The Scottish Government's Approach to Taxation within the Budget
Submission by the Chartered Institute of Taxation

1 *Introduction*

1.1 The Chartered Institute of Taxation (CIOT) welcomes the opportunity to provide a written submission to the Finance and Constitution Committee of the Scottish Parliament in advance of the roundtable evidence session on the Scottish Government's approach to taxation within the Budget on 12 December 2018.

1.2 We welcome the supporting documentation provided by the Scottish Government in connection with its Budget for 2019-20, including the Analytical Note on Impacts on Income Levels and Equality, the factsheet on the income tax proposals and the Explanatory Note for the draft Scottish Rate Resolution.

1.3 We understand that the broad themes for discussion are:

- Tax policy divergence between Scotland and the rest of the UK (rUK);
- Number of taxpayers;
- Behavioural responses;
- Forecasts data issues and transparency.

1.4 We also note the Scottish Government's commitment to a taxation system that aims to follow Adam Smith's principles. These say that tax should:

- Be proportionate to the ability to pay;
- Provide certainty to the taxpayer;
- Provide convenience / ease of payment, and;
- Be efficient.

1.5 In addition, the Scottish Government has applied four key tests when developing its income tax proposals:

- Protecting the lowest paid taxpayers;
- Improving progressivity;
- Raising additional revenue;
- Supporting public investment in the Scottish economy.

1.6 As an educational charity, our primary purpose is to promote education in taxation. One of the key aims of the CIOT is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

1.7 Our stated objectives for the tax system include:

- A legislative process which translates policy intentions into statute accurately and effectively, without unintended consequences.
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
- Greater certainty, so businesses and individuals can plan ahead with confidence.
- A fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented).
- Responsive and competent tax administration, with a minimum of bureaucracy.

Scottish Income Tax

1.8 The proposals in relation to Scottish income tax include:

- To maintain the five rates at their current levels of 19%, 20%, 21%, 41% and 46%;
- To increase the size of the starter and basic rate bands by inflation;
- To freeze the higher rate threshold at its 2018/19 level of £43,430 and the top rate threshold at £150,000.

1.9 If we consider the proposals in relation to the Scottish Government tests set out in paragraph 1.5 above, we would agree that the decisions to increase the size of the lowest two bands and to maintain the rates of those bands at 19% and 20% help to protect lower paid employees. Arguably the very lowest paid employees are unaffected by any of the Scottish government's decisions on income tax, because they are already taken out of income tax entirely due to the UK Government's policy proposals in respect of the personal allowance, which applies throughout the whole of the UK. According to the Scottish government's equality analysis, 2 million individuals do not pay income tax as their earnings are below the personal allowance. In addition, the increase to the personal allowance counts for the majority of the reduction in Scottish income tax (up to £130 benefit due to the personal allowance compared to £0.49 due to the increase in the starter rate band of 19%).

1.10 The Scottish Government indicates that it has improved progressivity by freezing the higher rate and top rate thresholds. A progressive tax is normally considered to be a tax in which the tax rate increases as the taxable amount increases. We would agree that the overall approach to Scottish income tax (and the introduction of two new rates and bands with effect from 2018/19) is progressive. We think it is less clear that the freezing of these two thresholds improves progressivity; in money terms, they would seem to maintain the *status quo*, but arguably progressivity is increased when inflation is taken into account. In both 2018/19 and 2019/20, the average tax rate increases (albeit not evenly) as one progresses up the income scale, which is one measure of progressivity. Ideally, the marginal rate also increases in this way, and the average rate is lower than the marginal rate. The marginal rate increases as expected (apart from the kink caused by the removal under UK-wide rules of the personal allowance for those with incomes over £100,000 – this means that the marginal rate between £100,000 and £125,000 is 61.5%, before falling back down to 41%).

1.11 In respect of the final two tests, to raise additional revenue and to support public investment, we note that the Scottish Fiscal Commission forecasts additional revenues due to the proposal to freeze the higher rate threshold. Whether or not these tests are met will only be confirmed once the outturn figures are available for 2019/20 – these are expected in summer 2021.

1.12 Given the Scottish Government's commitment to a taxation system that aims to follow Adam Smith's principles, we briefly consider the proposals in this context. With its structure of five rates and bands, and increasing rates of tax, the Scottish income tax continues to mean that Scottish income tax liabilities reflect the ability to pay of the taxpayer. The Scottish Government has committed to the continuation of this structure for the remainder of this Parliament, providing a degree of certainty to Scottish taxpayers, which is welcome. HM Revenue & Customs (HMRC) continue to administer and collect Scottish income tax, as income tax is a shared tax, rather than being fully devolved. The Pay As You Earn (PAYE) system is convenient for the taxpayer, albeit not necessarily always transparent and simple to understand. PAYE and self assessment are generally efficient means of collecting income tax.

1.13 The first tax policy divergence between Scotland and rUK occurred in 2017/18, when there was a difference in the higher rate thresholds. More significant divergence arose in 2018/19, with a move to a five rate and band structure for Scottish income tax, increases to the higher and top rates of tax and a more significant gap between the higher rate thresholds. While the overall picture remains broadly the same in 2019/20 as in 2018/19, there is a greater gap between the higher rate thresholds, with the UK threshold being set at £50,000, compare to £43,430 for Scottish income tax. Due to the starter rate of 19%, Scottish taxpayers earning £26,993 or less will pay less income tax (around £20) than those earning the same amount elsewhere in the UK – this amounts to roughly 55% of Scottish taxpayers. Scottish taxpayers earning more than £26,993 will pay more than those earning the same amount in the rest of the UK. The extra income tax payable by Scottish taxpayers rises unevenly, such that a Scottish taxpayer earning £30,000 will pay £30 more, but a Scottish taxpayer earning £50,000 will pay £1,544 more than a rUK taxpayer earning the same amount. This may lead to behavioural responses (see paragraph 2.9 below).

1.14 The creation of a five rate and band structure with effect from 6 April 2018 has led to complexities for HMRC in administration of the tax, and for taxpayers in understanding their tax position. As the structure remains steady for 2019/20, no further legislative changes to deal with these effects are required, but the discrepancies or complexities remain, in areas such as relief at source on pension contributions, Gift Aid relief and relief for landlords on mortgage interest.

1.15 The number of Scottish taxpayers is to some extent dependent on UK tax policy and in particular on the level of the personal allowance. This has increased significantly in recent years. In 2019/20 it will be £12,500, meaning that of 4.5 million adults in Scotland, only 2.5 million will earn enough income to pay income tax. Not only do further increases in the personal allowance not benefit those on the lowest incomes (more targeted benefits policies might better assist those individuals), but such increases also narrow the base of taxpayers, potentially making tax revenues more volatile. This is due to the following: the Scottish income taxpaying population is heavily concentrated in the basic (1 million) and intermediate (864,000) rate bands, with only 351,000 higher rate taxpayers and 16,000 top rate taxpayers. Despite this spread of taxpayers, income tax revenues are concentrated in the higher rate band, then the basic rate band. This means Scottish income tax revenues are vulnerable to behavioural responses by higher rate and top rate taxpayers.

1.16 Behavioural responses may arise because of the divergence in tax policy between the UK and Scotland; moreover, this may be exacerbated because of the link between the UK higher rate threshold for income tax and the Upper Earnings Limit for National Insurance contributions (NIC). This means that Scottish taxpayers face a combined effective marginal income tax and NIC rate of 53% (41% + 12%) if they are employees, or 50% (41% + 9%) if they are self-employed, on earned income that falls between the Scottish higher rate threshold of £43,430 and the UK higher rate threshold / NIC Upper Earnings Limit of £50,000. This scenario also arose in 2018/19, but the band affected was smaller, affecting income between £43,430 and £46,350. The Scottish Fiscal Commission estimate that this will affect around 120,000 taxpayers.

1.17 Perhaps the most likely behavioural response by self-employed Scottish taxpayers who are able to do so, would be tax motivated incorporation, exploiting the fact that business income tax rates fall within the devolution settlement but corporation tax and dividend income tax do not. Incorporation is often popular throughout the UK due to NIC savings, as well as tax savings and other non-tax factors. It should however be noted that the scope for this behaviour is limited in the following ways: only those who are self-employed can incorporate; and UK policies on off-payroll working for both the public and private sector reduce the scope for some to incorporate. Another possibility is that some taxpayers might arrange their lives so that their residence is in the rUK and they do not have Scottish taxpayer status. In addition, individuals contemplating moving to Scotland to live may be less likely to proceed. Some taxpayers will be more able to alter their residence status than others – it is likely these would include those with higher levels of income (and wealth), those who have fewer ties to Scotland and those who already have a place to live somewhere else in the UK. Other behavioural responses can include decisions about how many hours to work, tax planning such as how much to pay in pension contributions or how much Gift Aid donations to make, as well as tax avoidance and evasion. The material likely behavioural responses seem most likely to be the preserve of those paying tax at the higher and top rates of tax. It is expected there will only be 351,000 higher rate taxpayers in 2019/20 and 16,000 top rate taxpayers. However, as higher rate taxpayers contribute 43.1% of income tax revenues and top rate taxpayers contribute 15.7% of revenues, strong behavioural responses by this relatively small number of taxpayers would have a significant effect on revenues.

Land and Buildings Transaction Tax

1.18 The proposals in relation to Land and Buildings Transaction Tax (LBTT) include:

- To increase the Additional Dwelling Supplement (ADS) rate from 3% to 4%;
- To reduce the lower rate of non-residential LBTT from 3% to 1%;
- To increase the upper rate of non-residential LBTT from 4.5% to 5%;
- To reduce the starting threshold of the upper rate from £350,000 to £250,000;
- To consult further on plans to introduce reliefs for the seeding of properties into a PAIF or CoACS and the exchange of units in a CoACS.

1.19 We consider these proposals in the light of Adam Smith's principles. The ADS is one, single rate that applies to all transactions within the scope of the legislation, provided the relevant consideration exceeds £40,000. In and of itself, therefore, it is arguably not proportionate to the ability to pay. In combination with the residential rates and bands of LBTT however, the structure results in a tax that meets this principle. The changes to non-residential LBTT vary the average rates that apply to each transaction, but maintain the overall progressive structure and continue to produce a tax that is proportionate to the ability to pay. Moreover there is a question as to what extent it is practicable for each and every tax to serve each and every Adam Smith principle: if rates of LBTT become too high for larger-end transactions, one behavioural response is simply for there to be fewer such transactions, and it is arguably much harder to characterise this as (say) avoidance and perhaps take steps to counter it than might be the case with some possible behavioural responses to high income tax noted earlier.

1.20 The LBTT rate and threshold proposals do not change the degree to which there is ease of payment nor the efficiency of the tax. The proposed further consultation on reliefs for seeding and the exchange of units should, if it results in the introduction of these reliefs, increase efficiency for these property-holding structures. These reliefs, if introduced, should also provide certainty to the taxpayer. We note that the rate and threshold changes are intended to come into force from 25 January 2019. While we note the policy reasons for this approach, it is not ideal to change rates and thresholds part way through the tax year. The fact that this is proposed signals to investors and businesses that the Scottish Government may make such changes mid-tax year in future too, and therefore serves to remove some certainty.

Budget Process Review Group Recommendations

1.21 The Scottish Government committed to develop a new process for the planning, management and implementation of changes to the fully devolved taxes in its 2018

Programme for Government. This was in response to the recommendations made by the Budget Process Review Group.

1.22 We expect to see a consultation in February 2019; moreover the Scottish Government has committed to announcing the new process in the Scottish Budget 2020-21.

1.23 We welcome the continuing commitment to a consultative and collaborative approach. In addition, we are looking forward to contributing to these discussions, as we believe that it would be helpful to have a clear and simple process by which to implement changes to the devolved taxes, and in particular think that an annual Finance Bill process would be useful. This would allow for proper scrutiny, and for amendments to legislation when either errors have been discovered or when it has become apparent through practice that the legislation does not quite work as originally intended.

2 Acknowledgement of submission

2.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

3 The Chartered Institute of Taxation

3.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 18,000 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

The Chartered Institute of Taxation

18 December 2018

Written submission from Institute of Chartered Accountants of Scotland (ICAS)

Scottish Parliament

Finance and Constitution Committee

The Scottish Budget

17 December 2018

About ICAS

1. The following submission has been prepared by the ICAS Scottish Taxes Committee on behalf of the ICAS Tax Board. The Tax Board, with its five technical Committees, is responsible for putting forward the views of the ICAS tax community, which consists of Chartered Accountants and ICAS Tax Professionals working across the UK and beyond.

2. The Institute of Chartered Accountants of Scotland ('ICAS') is the world's oldest professional body of accountants and we represent over 21,000 members working across the UK and internationally. Our members work in all fields, predominantly across the private and not for profit sectors.

3. ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. From a public interest perspective, our role is to share insights from ICAS members in the many complex issues and decisions involved in tax and financial system design, and to point out operational practicalities.

General comments

4. ICAS is grateful for the opportunity to contribute its views on the Scottish Budget, as requested by the Scottish Parliament's Finance and Constitution Committee.

5. We have restricted our comments to matters in our area of expertise, which is the operational aspects of taxation.

6. We were pleased to meet with the Cabinet Secretary for Finance, Economy and Fair Work, along with a number of tax stakeholders, prior to the budget in order to discuss aspects of potential tax changes.

7. Devolution has introduced new opportunities, but also new complexities, with many moving parts to manage – with the interaction with the UK Budget, understanding how the block grant adjustments work, and the politics of managing perceptions. We have discussed this in a recent paper Devolving Taxes across the UK: Learning from the Scottish Experience[6].

8. We welcome the timing of the UK budget this year in relation to the Scottish budget – but believe the timing of the budgets in each jurisdiction should be governed by a more formal process that is designed to enable maximum collaboration between governments.

9. We have commented below on the specific points raised in the call for input.

Key budget changes in Scottish income tax (SIT) for 2019/20

10. The rates and bands for 2019/20 are as follows:

Band 2019/20	Band 2018/19	Band Name	Rate 2018/19 and 2019/20
£12,500–£14,549	£11,850–£13,850	Starter rate	19%
£14,549–£24,944	£13,851–£24,000	Basic rate	20%
£24,944–£43,430	£24,001–£43,430	Intermediate rate	21%
£43,430–£150,000	£43,431–£150,000	Higher rate	41%
Over £150,000	Over £150,000	Top rate	46%

Note: assumes the Scottish taxpayer has a UK personal allowance of £12,500 (reduced by £1 for every £2 of adjusted net income over £100,000).

Further points to note:

- The personal allowance is UK-wide and cannot be changed

[6] https://www.icas.com/__data/assets/pdf_file/0012/388497/Devolving-taxes-across-the-UK.pdf issued by the Scottish Taxes Policy Forum, a joint collaboration by ICAS and the CIOT

- The starter and basic thresholds increase by inflation whereas the higher rate threshold is frozen at £43,430.

Tax policy divergence between Scotland and the rest of the UK

11. Scottish taxes do not sit in isolation – they are interwoven within the UK tax regime and there are connections and constraints which this imposes. One particular example is the personal allowance which is set by Westminster and applies to all UK taxpayers with the effect that a significant proportion of the Scottish population are lifted out of income tax (44.6% in 2019/20[7]), in turn making the Scottish taxpaying base smaller.

12. The numbers around the Scottish taxpaying population include:

    - 44.6% of adults in Scotland will not pay income tax in 2019/20.
    - There are 2.5 million income taxpayers in Scotland.
    - A Scottish taxpayer earning £25,000 will be £140 better off in terms of income tax (primarily due to the UK-wide personal allowance increase).
    - Around 99% of Scottish taxpayers will pay less tax in 2019/20 than in 2018/19 (those who pay more are above the threshold where the personal allowance is withdrawn).
    - Taxpayers in Scotland and England will pay the same tax on earnings of £26,993.
    - Between £43,430 and £50,000, Scottish taxpayers will pay a combined marginal rate of 53% (41% SIT and 12% NIC).

Behavioural responses

13. Two matters that may influence taxpayers' behavioural responses converge around the higher rate thresholds for income tax. One is the comparison between the Scottish higher rate threshold at £43,430 with the higher rate threshold in the rest of the UK at £50,000. The other is the interaction between the income tax higher rate thresholds and the NIC upper threshold. Both these matters make SIT feel more expensive relative to other taxpayers in the UK – and may therefore have behavioural implications.

14. The higher rate income tax threshold which is set by Westminster and only applies to the rest of the UK indirectly challenges options in Scotland because there is a seemingly automatic reaction by the public to compare any devolved tax measure with that in the rest of the UK. The proposed higher rate threshold for Scottish taxpayers is lower than in the rest of the UK and, combined with the tax rates at the higher and top rates, Scottish taxpayers will pay more than their counterparts in the rest of the UK.

15. However, care needs to be taken in making comparisons. And these can be presented in a confusing manner that results in a lack of transparency and understanding. These comparisons can include:

    - For 2019/20 comparing a Scottish income taxpayer and a 'rest of UK' income taxpayer – is a Scottish taxpayer better off than their neighbours?
    - 2018/19 and 2019/20 – comparing a Scottish income taxpayer's circumstances from one year to the next – is a Scottish taxpayer better off from one year to the next?
    - A comparison that looks at income tax only, or one that takes into account both income tax and NIC. For some, income tax and NIC are both payroll deductions and the important matter is the final take-home pay; for others, NIC is a social security contribution and nothing to do with tax. To complicate this, key elements of income tax (the rates and thresholds) are devolved but NIC is reserved.

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[7] https://www.gov.scot/binaries/content/documents/govscot/publications/factsheet/2018/12/scottish-income-tax-2019-2020/documents/analytical-note-on-impacts-on-income-levels-and-equality/analytical-note-on-impacts-on-income-levels-and-equality/govscot%3Adocument see key findings

16. Within comparisons between Scottish taxpayers and those in the rest of UK in 2019/20, the difference in tax payable will be largely due to the revised 5-band structure with the one percentage point extra that was added to the higher and top rates last year, and maintained in this budget, and the freezing of the higher rate threshold.

17. Within comparisons for Scottish taxpayers from one year to the next, reductions in income tax payable come from a mixture of UK-wide measures (mainly due to the personal allowance) and Scottish measures (the setting of rates and bands, notably the higher rate threshold).

18. The behavioural implications of perceived increases in taxes can be divided into four categories, namely:

    - Individuals who are already Scottish taxpayers and living in Scotland
    - Individuals living outside Scotland who may be considering moving to Scotland
    - Growing businesses already operating in Scotland, and
    - Growing businesses operating outside Scotland.

    These are discussed further below.

National Insurance

19. There are two related NIC matters, which need a joint Scottish/UK approach to bring transparency and to address them. First, is the increase in NIC for any UK taxpayer as a result of the UK budget on 29 October. The UK higher rate threshold for income tax has gone up to £50,000, and the UK NIC upper threshold mirrors this. However, whilst the UK basic rate band for 2019/20 has widened by £3,000, the employee's NIC 12% band, which applies across the whole of the UK including Scotland, has widened by £3,442. On earnings up to £50,000 less income tax is collected, whilst more NIC is payable.

20. Second, a further anomaly arises in Scotland due to the interaction (or lack of it) between the UK-wide NIC upper threshold of £50,000 and the devolved higher rate threshold for SIT. Scottish taxpayers with income between £43,430 and £50,000 will pay a combined marginal rate of 53% (41% SIT and 12% employee's NIC). This was already a concern in 2018/19, but this budget is widening the 53% band in 2019/20.

21. For a 'rest of UK' taxpayer in 2019/20 with an income of £50,000 their position compared with 2018/19 will be a net increase in their take home pay of £520. This is made up of reduced income tax of £860 but £340 more national insurance.

22. For a Scottish taxpayer in 2019/20 with an income of £50,000 their position compared with 2018/19 will be a net reduction in take home pay of £200 made up of reduced income tax of £140 but an extra amount payable of £340 NIC.

    See the numerical illustrations in the appendix.

Scottish taxpayers

23. With the gap between the higher rate thresholds widening between Scotland and the rest of the UK in 2019/20, there may be behavioural consequences. For example, if an individual is in a position to mitigate their tax bill by incorporating and taking remuneration up to the personal allowance, with the remainder by dividend, this would divert any tax payable away from Scotland altogether and into the UK exchequer as corporation tax on company profits and income tax on dividend income.

24. Any taxpayer who views a tax bill as an unwanted cost may seek to minimise this and so divergent rates across income tax (Scottish and UK), corporation tax and capital gains tax lend themselves to tax planning behaviours such as business incorporation by an individual who wishes to be paid in dividends rather than a salary.

25. We discussed this in our submission to the Committee's inquiry into a 'Scottish Approach to Taxation' – and increasing the amounts of Scottish income tax payable relative to the rest of the UK, along with the UK proposal to reduce corporation tax to 17% from April 2020 can only encourage this type of tax planning.

26. There may also be a less quantifiable move to minimise taxable income in the middle band where the 53% charge sits. Employers may decide to reconfigure remuneration packages to enable their employees to exchange salaries/wages for NIC-efficient items such as pensions or holidays; or individuals may increase their pension contributions or reduce their workload and hence their taxable pay. All small measures, but nevertheless, measures which could add up across the piece.

Will individuals wish to migrate to Scotland?

27. There is also the issue of whether Scotland is now portrayed as 'expensive' and, alongside the tax equalisation packages put in place by the MoD[8], there is anecdotal evidence that higher rates may be a disincentive when employers seek to recruit from outside Scotland, particularly for higher-paid, professional staff. Given Scotland's excellent transport links, higher tax rates in Scotland may also encourage some higher-paid individuals to maintain their main home south of the border while working here.

Businesses

28. Growing businesses already operating in Scotland and growing businesses operating outside Scotland will, in each case, be considering whether their best strategic objective would be to expand their workforce inside or outside Scotland.

Forecasts, data issues, and transparency

29. There have clearly been issues around aspects of the forecasting of Scottish income tax, as discussed in the recent Scottish Parliament's Finance and Constitution Committee report 'Pre-budget scrutiny report'[9]. There seems to be a lack of sound data, as revealed by the differences between the forecast and actual numbers of higher and additional rate taxpayers in Scotland (paragraph 73).

Table 5. Number of Income Taxpayers, 2016/17

	Higher Rate	**Additional Rate**
SFC May Forecast	308,500	15,500
HMRC Outturn Figure	294,000	13,300

30. We would encourage the development of better data than is currently available. HMRC's identification of Scottish taxpayers is a basic example of an area where accurate and comprehensive information flow is essential to the Scottish Government. Clearly, the information flow should be barrier-free and mutually recognised as beneficial, to ensure that tax revenues on both sides can be optimised and any potential loopholes identified and resolved expeditiously.

Land & Buildings Transaction Tax (LBTT)

31. Changes are proposed to LBTT as follows from 25 January 2019:

- The rate of Additional Dwelling Supplement will change from 3% to 4%, and
- LBTT rates and thresholds for non-residential properties are to be amended such that an anticipated two-thirds of all non-residential transactions will result in less LBTT payable.

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[8] https://www.gov.uk/government/news/military-personnel-in-scotland-protected-from-tax-hikes

[4] published 7 November 2018 https://sp-bpr-en-prod-cdnep.azureedge.net/published/FCC/2018/11/7/Pre-budget-scrutiny-report-2/FCCS052018R12Rev.pdf

32. The Scottish Budget also announced the intention to introduce two reliefs from LBTT for property investment funds, which we welcome.

Process

33. LBTT has been notable in that since its commencement in April 2015 there have been several changes to it. These have included:

- A new charge to tax – the Additional Dwelling Supplement
- A new relief – first-time buyer relief, and
- Removal of anomalies – for example around group relief.

34. A key issue is that there is no regular process for bringing forward and considering such changes, and it would be helpful if there was. There is also a need for 'care and maintenance' measures in the existing tax law so that, if stakeholders such as Revenue Scotland find parts of the legislation do not work as intended or the legislation does not work as taxpayers require from a commercial perspective, there is an opportunity to revisit the law. To date, possible amendments to tax law have been raised on an ad hoc basis.

35. The increase in the charge to Additional Dwelling Supplement is likely to sharpen concerns amongst taxpayers about a number of perceived anomalies in the legislation, particularly where two people become a couple, where a couple split up, or where market conditions delay the sale of the old property on a simple house move.

36. An annual UK Budget is needed because income tax is an annual tax – it must be enacted every year. In Scotland there is no such requirement, other than for an annual Scottish rate resolution setting the income tax rates and bands. This limited annual tax procedure is not enough. To maintain and improve Scottish taxes a broader, regular, formal, parliamentary process is needed. It is encouraging to note that included in the Scottish Government's legislative programme for 2018/19 is a pledge to reform the way in which devolved tax decisions are planned, managed and implemented[10]. It is hoped this will be put in place as soon as possible.

37. It is highly desirable that any process to implement tax change will be enacted in primary legislation. To date, there has been a tendency to use secondary legislation in the form of Scottish Statutory Instruments instead of primary legislation, such as with the most recent LBTT Group Relief (No.222) and First Time Buyer relief (No.221) orders of 2018. ICAS does not believe that this is an appropriate way to exercise tax powers because it lacks both visibility and active parliamentary consideration. This should encourage full debate about likely repercussions of changes, such as administrative costs to businesses of updating systems – a factor often under-estimated.

[10] https://www.gov.scot/publications/delivering-today-investing-tomorrow-governments-programme-scotland-2018-19/ page 61

Appendix 1

Combined income tax and NIC liabilities

Rest of UK tax payers 2019/20 v 2018/19

Scottish taxpayers 2019/20 v 2018/19

Tax computation for a rest-of-UK taxpayer, 2019/20 and 2018/19 – earnings of £50,000

Tax Computation	2019/20 £	2019/20 £	2018/19 £	2018/19 £
Earnings:	50,000		50,000	
Less: PA	(12,500)		(11,850)	
Taxable earnings	37,500		38,150	
Income Tax @ 20% on:	37,500		34,500	
Income Tax due:		7,500		6,900
Income Tax due @ 40% on:	n/a		3,650	
Income Tax due:	n/a	nil		1,460
Total income tax due		7,500		8,360
Employee NICs @ 12% on:	41,368		37,926	
Employee NICs due:		4,964		4,551
Employee NICs due @ 2% on:	n/a		3,650	
Employee NICs due:		Nil		73
Total Employee NICs due		4,964		4,624
Total Income Tax and NICs due:		12,464		12,984

In 2019/20 in the rest of the UK, compared with 2018/19, the taxpayer's total income tax and NICs liability **reduces** by £520, although the income tax payable reduces by £860. While the overall liability reduces, the NICs payable on the same income actually **increases** by £340.

Tax computation for a Scottish taxpayer, 2019/20 and 2018/19 – earnings of £50,000

If the taxpayer was a Scottish taxpayer for 2018/19, earning the same salary, they would pay £824 more than in the 'rest of the UK'.

For 2019/20, due to the holding down of the higher rate band, they will pay £1,544 more, as the following table shows:

Tax Computation	2019/20 £	2019/20 £	2018/19	2018/19

			£	£
Earnings	50,000		50,000	
Less: PA	(12,500)		(11,850)	
Taxable earnings	37,500		38,150	
SIT @ starter rate 19% on	2,049		2,000	
SIT due:		389		380
SIT @ basic rate 20% on	10,395		10,150	
SIT due:		2,079		2,030
SIT @ intermediate rate 21% on	18,486		19,430	
SIT due:		3,882		4,080
SIT @ higher rate 41% on	6,570		6,570	
SIT due:		2,694		2,694
Total SIT due		9,044		9,184
Employee NICs @ 12% on:	41,367		37,925	
Employee NICs @ 12%		4,964		4,551
Employee NICs @ 2% on:	n/a		3,650	
Employee NICs @ 2% on n/a		Nil		73
Total Employee NICs due		4,964		4,624
Total Income Tax and NICs due		14,008		13,808

Due to the divergence in Scottish income tax rates and bands from the rest of the UK, the Scottish taxpayer’s increased total tax bill is mostly due to the higher income tax payable at this level of earnings.

However, both Scottish and UK taxpayers will each face an increased NICs charge of £340 on these earnings in comparison to 2018/19.

Scottish taxpayers in the income bracket of £43,430 - £50,000 also face a combined marginal rate of 53% on this income.