



Finance Committee
The Scottish Parliament
Edinburgh
EH99 1SP

27 September 2016

Dear Sirs,

A Scottish Approach to Taxation

We welcome the opportunity to contribute to the Finance Committee's (the Committee) debate on the way forward for the Scottish tax system. It is a rare opportunity to do so at such an early stage in the development of a tax system, and we commend the Committee for its commitment to consulting with a wide range of stakeholders on this issue.

Modernisation and reform of the tax system is an issue that we are engaged with through our Paying for Tomorrow campaign.¹ Whilst this addresses the UK tax system as a whole, the findings are also relevant to the development of the Scottish tax system, as there is an opportunity to consider building many of the key points into the Scottish system at an early stage. We have used both citizen's and business juries to engage with a variety of groups to take a strategic view of tax reform and our comments below reflect that ongoing discussion.

Devolution in particular has become an important feature of the UK tax system and there is currently momentum for that process to continue, with further changes to come in Wales and Northern Ireland, as well as moves towards decentralisation within England. As such, Scotland is very much a pathfinder in the process of managing taxes and developing tax policy in the new devolved environment.

Executive summary

Principles

In our view, the principles identified by the Scottish Government as underpinning the Scottish tax system are generally being applied in implementation and design of the devolved taxes, but in our opinion there are case where greater certainty and efficiency could be achieved. The principles themselves (as we have commented elsewhere) are appropriate and have been welcomed by business.

¹ <http://www.pwc.co.uk/issues/futuretax.html>

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Consistent application will, in our view, give rise to a tax system that supports the growth of the economy.

Scope for a fundamentally different approach to taxation

Whilst there is scope to develop a simpler and more efficient tax system, there are also factors that may limit that scope. The constraints on the Scottish tax system are fundamentally the same as those facing any tax system i.e. cost, capacity, competition, and confidence, as follows.

- **Cost:** efficiency in collecting and managing tax is always a constraining factor in making and implementing policy.
- **Capacity:** the ability of the tax collection authority to collect and enforce taxes depends on recruiting, retaining and training staff with appropriate skills, as well as in continuous investment in developing robust systems.
- **Competition:** the tax system as a whole can help to provide Scotland with a competitive advantage in terms of both inward investment and indigenous growth but equally it will face challenges from other regions within the UK and other countries for such investment.
- **Confidence:** it is vital for any tax system to maintain the confidence of the tax payer – both in terms of the robustness and fairness of the system and also in the transparency and accountability of spending of revenues raised. Confidence in the system and in the tax-policy making process also reduces the incentives for some behavioural responses.

EU law also places some constraints on the tax system but these may change following the result of the EU referendum.

These factors will place some limits on the tax system, whether administered by HMRC or Revenue Scotland. Each may play a greater or lesser part over the lifecycle of the tax system, but overall they are the main constraints that we believe are placed on the development of both tax policy and the process of implementation.

We have considered the issues noted in your call for views in more detail below, with specific reference to the Scottish tax system.

How can the Scottish Government's four principles to underpin Scottish taxation policy best be achieved?

How does the current taxation regime and proposals for newly devolved taxes align against these four principles?

The principles set out by the Scottish Government (as we have previously noted) are a good basis for the development of the tax system. They align closely with the principles identified by our Paying for Tomorrow campaign. Our Citizen's Jury event concluded that any tax system should be based on the following principles:²

- transparent in how revenue is raised and spent;
- simple to understand and navigate;

² PwC website: <http://www.pwc.co.uk/issues/futuretax/the-key-principles-that-should-govern-the-uk-tax-system.html>



- proportionate to citizen's ability to pay;
- fair, with every person and organisation paying their correct sum;
- certain, so everyone should know what they will owe in a system that rarely changes;
- supportive, with consistent advice and help for citizens; and
- the system should not punish people for doing the right thing. It should not discourage work, savings or planning for your family's future.

To ensure that these principles continue to be reflected in the Scottish tax system, we would recommend consideration of the following operational priorities. These priorities were also discussed in our most recent business jury event.³

- Consultation in a real and timely manner from wide range of stakeholders.
- Careful drafting of legislation and time built into the process for review of draft legislation, guidance and regulations.
- Transparency including clarity of purpose stated upfront and also review of whether policy objectives are met.
- Changes to be minimal and complexity only introduced where necessary.
- Ease of compliance to be considered.
- Divergence from UK should only occur where necessary for policy or practical reasons e.g. to enhance certainty or simplicity.
- Further efforts are needed to communicate with the public about how tax is raised and how it is spent in Scotland, including the division of such between the Scottish Government and local authorities.

In our opinion, these actions should minimise the need to make continual change to legislation, prevent unintended consequences and also help to promote compliance.

The current Scottish system has been developed with these principles in mind, but it is not easy to achieve all of them consistently. Examples to date include the following.

Efficiency:

- Delays in receiving Land and Building Transaction Tax (LBTT) clearances have been experienced – up to four months in some cases. Such delays are particularly difficult in commercial transactions as the uncertainty can prevent such transactions taking place.

Certainty:

- Whilst legislation in many places mirrors provisions in UK legislation, HMRC guidance has not been carried across. This guidance is often crucial in understanding how the tax authority will seek to apply the legislation and often clarifies points in (particularly older) legislation where the drafting is unclear. There has been a particular problem in relation to the application of LBTT to demergers that has recently been resolved but which was time-consuming and impacted on efficiency for all concerned,

³ <https://atpwc.co.uk/#/story/our-business-jury-debates-the-future-of-tax>



- Guidance on the treatment of waste fines for Scottish Landfill tax has only recently been made available.

Proportionate:

- The additional dwelling supplement is not per se proportionate to ability to pay.

Should future tax changes be ring-fenced and if so, how? If not, why?

There is an increasing trend for new taxes in the UK to come with some element of hypothecation e.g. the proposed soft drinks industry levy, the apprenticeship levy, and the English council tax precept. This can be a popular practice with tax payers as it gives an additional layer of accountability and transparency. As such it can help to build confidence in the tax system and increase willingness to pay. One of the themes that emerged from our citizen's jury was a concern as to the lack of transparency as to how taxes are spent and whether 'value for money' was achieved by the tax system. Positive views on ring-fencing were expressed at the beginning of the citizen's jury event, as this was seen as a means of gaining clarity around what additional taxes were spent on, as well as being able to see whether the additional had resulted in expected outcomes. Over the course of the event that view shifted towards a greater desire for more transparency as a whole, part of which might involve hypothecation. The general view was that the priority should be to achieve greater openness about the justification for the change and what the additional revenue would be used for, with ring-fencing as one potential method.⁴

If ring-fencing is applied to new taxes (or to tax increases), there is, therefore, onus on governments to ensure that the hypothecation not only happens, but is seen to have a beneficial effect. Transparency over policy objectives and results was of keen interest to our citizen's and business juries, especially where additional complexity is introduced (as would be the case with ring-fencing).

It should therefore be recognized that ring-fencing brings with it a greater degree of complexity and any benefits would depend on it being well-understood and widely-supported. Nevertheless, whilst strict ring-fencing builds in complexity and rigidity to the system, it is clear that there is more support for a tax system that can demonstrate value for money, which should help to enhance certainty and efficiency. Transparency in purpose, implementation and outcome of any tax changes (possibly supported by selective use of ring-fencing) should enhance the integrity of the tax system. This focus on the outcomes of a change to the tax system (rather than solely on what revenues might or might not be raised) would, in our view, be a beneficial development.

Is there scope for a fundamentally different approach to taxation in Scotland? To what extent do potential behavioural responses limit options for tax changes in Scotland?

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? Are there any other administrative limitations to the emergence of a Scottish tax system?

We have considered these questions from the perspective of whether there is scope for a different approach to policy-making and any constraints on policy choices, rather than in terms of tax policies

⁴ <http://www.pwc.co.uk/issues/futuretax/june-2014-the-people-decide.html>



themselves as that is for governments to determine. In relation to the latter, there is clearly scope for divergence from other governments around the outcomes desired from tax policy, but certain key constraints will also limit the scope to implement those policies. This is common to all tax jurisdictions, and reflects the inevitable compromises that have to be made within a tax system.

One obvious current constraint is the need to comply with EU law and the application of EU taxes such as VAT. Some of these constraints may fall away depending on result of the negotiations for the UK's exit from the EU. This may in turn open up scope for greater devolution within the UK, but also greater scope for devolution within Scotland, including greater capacity for selectivity across industries for example.

All tax systems and policy choices are constrained by similar factors which we have grouped into four categories: cost, capacity, competition, and confidence.

Cost

The cost to government of administering a particular policy places practical limits on the tax system. Administrative feasibility should therefore be a key consideration, especially where the intention is to operate with a small, efficient tax authority and to maintain a low operational costs ratio. This does limit the complexity of the system that can be administered. This was recognised by the Commission on local tax reform in its consideration of the practicalities of introducing a local income tax.⁵

In this context, we believe that using HMRC to administer income tax in Scotland only imposes a limitation on the development of the Scottish income tax system if HMRC is unable to administer a particular change envisaged by the Scottish government, or if the cost of doing so is prohibitive. The current status with rates and bands being devolved is unlikely to be beyond HMRC's capacity to administer. If further devolution over the tax base for income tax is envisaged, the comparative costs of transferring the administration of income tax in full to Revenue Scotland, or continuing to use HMRC (and bearing their additional costs), would need detailed analysis to enable a decision to be taken. Account would need to be taken of the digitalisation agenda announced by HMRC and currently under consultation.

The other issue to be considered is the costs borne by those collecting the tax under consideration. New taxes such as the apprenticeship levy and the proposed soft drinks levy are collected by businesses and impose additional compliance costs on businesses affected. As noted by the OECD, '*significant compliance costs for taxpayers are likely to reduce the efficiency of tax reforms but may also impact on equity effects*'.⁶ In particular the OECD noted that higher costs can bear disproportionately on small firms or those with low incomes.

As noted above, taxpayers increasingly desire a more transparent system where they can see value for money both in the tax policies and also in their administration. Confidence in the administration of tax increases efficiency, and is also a factor in preventing non-compliance.

⁵ Commission of Local Tax Reform, "Just change: a new approach to local taxation". Para 13.14.

⁶ Brys, B et al (2016), "Tax Design for Inclusive Economic Growth", OECD Taxation Working Papers, No. 26, OECD Publishing, Paris. P.42



Capacity

The capacity of the tax authority to collect and manage the relevant taxes must grow with the complexity of the system, if it is not to become a constraint on policy. Having a sufficient number of people with the right skills and experience to operate the tax system is fundamental. Good policy badly implemented is damaging to confidence and efficiency. It should also be stressed how important a skilled and well-resourced tax authority is to confidence and prevention of abuse. Recruiting and training the right staff requires continuous investment.

The capacity of the tax authority to generate and analyse data is also beneficial, not just to enforcement and collection, but also in helping to design better policy. A proper assessment of the outcomes of any tax changes relies on good data being available (including data on the impact of additional compliance burdens). Transparency of such data can also enable the tax authority to engage more widely and consult effectively. Lack of such data is a constraint on the capacity of the tax authority, and hence on the tax system as a whole.

Competition

Scope for designing a fundamentally different tax system in Scotland is also constrained by competition both within the UK and also globally. Tax competition already exists within the UK, and is likely to grow as further fiscal devolution is implemented in other parts of the UK. It is also important to note that tax is only one factor in any business decision as to investment or location.

This has already had an impact on certain tax policies e.g. the setting of rates for Scottish landfill tax is essentially constrained by UK rates as creating tax competition in this field would be unhelpful given the purpose of the tax. Equally, in setting rates for LBTT (and in particular in relation to the additional dwelling supplement), consideration had to be given to the rates and reliefs in stamp duty land tax (SDLT). These considerations are, of course, common to all tax systems, but perhaps may offer greater restrictions in the case of Scotland. Tax competition can be harmful if it results only in the displacement of economic activities from other areas.

The discussions around the introduction of the additional dwelling supplement to LBTT illustrates this issue. Consideration was given by the Committee as to whether not introducing the additional charge could create tax competition that would be beneficial to Scotland. Nevertheless, it was concluded that the risk of distorting the Scottish housing market if such a rate was only introduced into SDLT was greater than the potential benefit of attracting more inward property investment.

There are also policy constraints deriving from behavioural responses to tax competition. Whether the desired outcome of any tax change can be achieved has to factor in any likely response from taxpayers. The impact of changes to both air passenger duty and also income tax would need to consider such behavioural responses. The mobility of the tax base is a constraint on policy choices.

Such responses are hard to predict and (as noted above) the better the data available, the better any tax elasticities can be estimated and hence outcomes predicted. Confidence of the taxpayers in the tax system as a whole tends to reduce elasticities. Greater transparency around policy making and the use of revenues enhances that confidence and reduces behavioural effects.



Competition is of course also not simply a matter of rates, but also reflects the relative simplicity and certainty of a tax system. Inward investment decisions, for example, are based on a wide range of factors and on a view of the tax system as a whole.

However, any element of tax competition carries with it risk (and potential rewards) and, therefore, an open discussion on what level or scope of tax competition is considered appropriate and what rewards are anticipated would be beneficial. In our view, it would need to be targeted and widely-understood. If there is greater scope for tax competition within the UK following the UK's potential departure from the EU, this balance between risk and rewards from tax competition may become even more relevant as a policy constraint.

Confidence

The confidence of taxpayers is vital to the system and helps underpin its efficiency. Any lack of confidence undermines the ability of the government to make and implement tax policies, and hence raise revenues. It is important that any tax policy commands general acceptance amongst the public and the business community. As such it is important to look at ways of generating greater levels of public understanding and engagement in tax policy.⁷ High levels of complexity can lead to unacceptable levels of taxpayer uncertainty with detrimental effects on efficiency and equity. As the Office of Tax Simplification has pointed out, complexity is sometime necessary to achieve specific outcomes, but avoiding unnecessary complexity is certainly beneficial.⁸ Simplifying the UK tax system is challenging as it involves dismantling legislation; there is an excellent opportunity for the Scottish system to opt for simplicity for the start and make choices to introduce complexity only when justified by clearly-articulated policy choices. Transparency over such policy choices and accountability for the outcomes also improve confidence in the system.

Trust in the system requires not only robust tackling of non-compliance, but also confidence in the capacity of government to spend revenues effectively and in line with the outcomes supported by the public. Tackling evasion in particular enhances the perception of compliant taxpayers of the system as fair (and hence increases compliance and reduces costs).

Local taxation

These constraints apply both nationally in Scotland and also to local taxation. However, local taxation is an area where the Scottish Government has more immediate scope to make changes and has already signalled its intention to take a different approach to the current position (in relation to council tax and business rates). This is mirrored in the rest of the UK, where plans for greater fiscal devolution to local authorities is also under discussion. Once local authorities are in the position of retaining 100% of business rates, they will bear considerable tax risk and will be more directly exposed to tax competition. Support for managing this significant change will be needed.

In considering other new local taxes such as tourist taxes or an infrastructure levy, our view is that the same constraints as above will apply, and that these should involve perhaps even greater levels of local consultation and transparency.

⁷ <http://www.pwc.co.uk/issues/futuretax/pwc-in-the-classroom-to-teach-teenagers-about-tax.html>

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https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/435704/Principles_of_avoiding_complexity_June_2015.pdf



Please do not hesitate to contact us if you would like to discuss the views above in more depth or if you would like more detail on our Paying for Tomorrow campaign.

Yours faithfully,

David Glen

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