STUC response to the Finance Committee's inquiry into 'a Scottish approach to taxation'

1 Introduction

1.1 The STUC welcomes the opportunity to contribute to this important inquiry. With significant new tax powers about to accrue to Scotland, it is hugely encouraging that the Committee is engaging with Scottish society to consider how a distinct approach to taxation may be developed.

1.2 The STUC has long been frustrated over the quality of debate about taxation issues in Scotland and beyond: serious evidence is rarely deployed in support of calls to cut business and personal taxes; positions are often deeply entrenched and ideological; superficial or irrelevant comparisons are frequently made with the tax systems of other nations. Worryingly, one expensive measure - the Small Business Bonus - has never been properly evaluated. Government has been persistently timid in considering changes to local and personal taxation and the evidence recently presented to justify the Scottish Government's current position on Income Tax was wholly inadequate.

1.3 The STUC hopes this inquiry will be the start of a more mature consideration of the future of Scotland's tax system. In the pursuit of a fairer, more democratic and resilient economy, an effective tax system is of pivotal importance. Tax will form a key part of any credible strategy to reduce inequality. Differences in tax policy are a major factor explaining why the trajectory of inequality has been so markedly different in developed nations subject to the same global trends in trade and technology.

1.4 While valuable lessons may be learned from experience elsewhere, the STUC is firmly of the view that the tax system in Scotland must be allowed to evolve in a way that is compatible with Scottish preferences, institutions and economic circumstances. It will not be possible to simply import models from abroad.

1.5 In this submission the STUC proposes additional principles and measures that we believe will help Scotland move towards a system that will support our social and economic objectives; objectives that are currently broadly shared with the Scottish Government. We recognise that a tax system that generates sufficient, stable revenues to fund excellent public services and reduce inequalities is unlikely to emerge overnight. Implementing significant changes across a range of taxes with an insufficient understanding of behavioural effects and unintended consequences could prove risky. That said, existing knowledge and information about Scotland's economy, labour market and current tax system is sufficient to justify much bolder measures than those implemented to date.

2 Committee's questions

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

2.1 The STUC endorses the four principles but is concerned that, combined, they fail to form a robust framework around which a tax system can be constructed to effectively support the Scottish Government's laudable social and economic objectives. Indeed, by failing to adequately confront issues of scale and fairness, an undue focus on these principles risks distracting from some pressing challenges.

2.2 Of course any tax system should endeavour to be efficient and provide ease of payment. Insofar as it's possible in a dynamic economy, certainty for the taxpayer is also a reasonable objective. Individual taxes, *and the system as a whole*, should be as far as possible proportionate to the ability to pay. However, meeting this one objective will not necessarily lead to the construction of a system that supports the Scottish Government's commitment to tackling inequality; one of the 'twin pillars' of its economic strategy.

2.3 Therefore, the STUC suggests the Scottish Government should introduce at least three more principles:

- *Taxation policy must be consistent with achieving the Scottish Government's key policy objectives*;
- *Taxation policy must limit opportunities for evasion, avoidance and non-payment and prioritise effective action – including appropriately severe penalties - where wrongdoing is identified;*
- *Administration of the tax system – including action to identify and penalise evasion, avoidance and wrong-doing - must be adequately resourced.*

2.4 The STUC also believes that, in designing a new, distinct Scottish approach to taxation, the Scottish Government must also be mindful of the following issues:

2.5 **Scale** – progressivity is of course an essential feature of a fair and robust tax system but, in focusing on the progressivity of individual taxes and of the system in general, it is possible to lose sight of the importance of *scale*. There is no point in having a highly progressive system if that system produces total tax revenues (TTRs) which are insufficient to fund the level and quality of public services demanded by Scotland's citizens or the transfers that support society's poorest and most vulnerable people.

2.6 Experience across the developed world suggests that the link between scale and progressivity is complex; the countries that generate the highest TTRs (as a % of GDP) do not necessarily have the most progressive *systems* although income taxes may be more progressive (higher earners do tend to pay higher marginal rates of income tax which also apply at lower thresholds). There are trade-offs between the level of transfers and the progressivity of the taxes that fund them.

2.7 The OECD has found that:

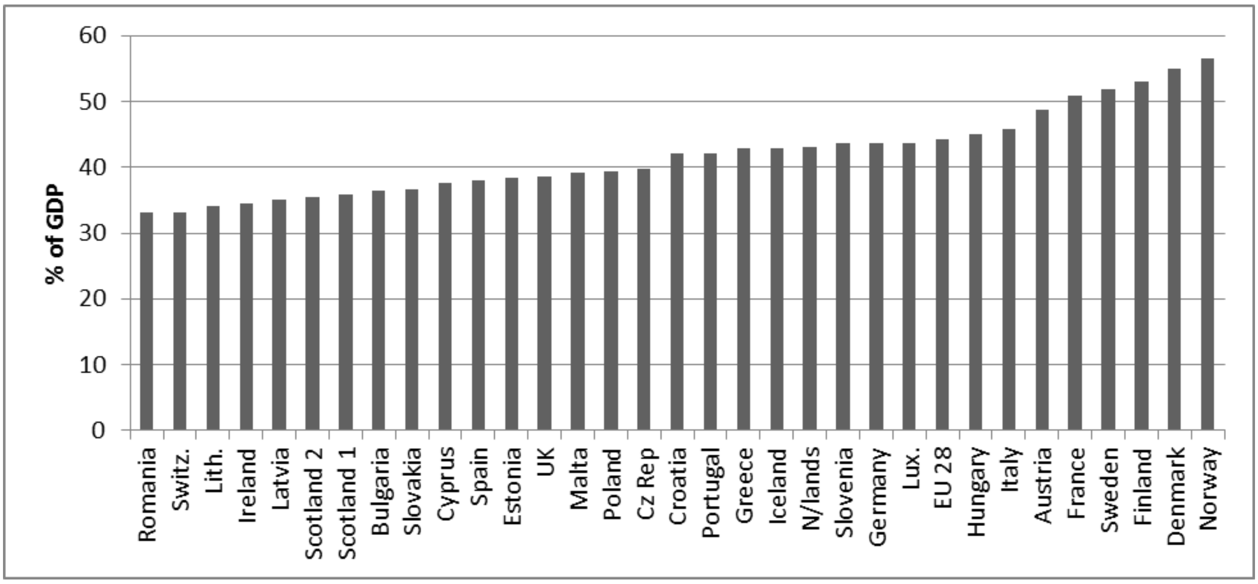
"The redistributive impact of taxes varies less across countries than the large differences in tax-to-GDP ratios would suggest. Indeed, some high tax countries show little progressivity, either because: i) the tax mix favours consumption taxes and social security contributions over more progressive personal income taxes, ii) the progressivity of tax schedules is limited; or iii) statutory progressivity is weakened by tax expenditures that benefit high-income groups most…Some of the countries with the highest inequality in market income tend to redistribute more through household taxes than less unequal countries"[1]*.*

2.8 Total tax revenues are significantly lower in Scotland than in many of the smaller European nations consistently invoked as models for Scotland. These nations also tend to have lower inequalities of income and wealth. The STUC believes that TTRs in Scotland will have to rise over time to facilitate the Scottish Government's social objectives but we don't underestimate the challenges involved: the Scottish Government doesn't have full control of taxation; Scotland's high level of integration with rUK is likely to constrain tax policy and, as yet, Scottish voters haven't shown any strong inclination to support higher taxes.

---

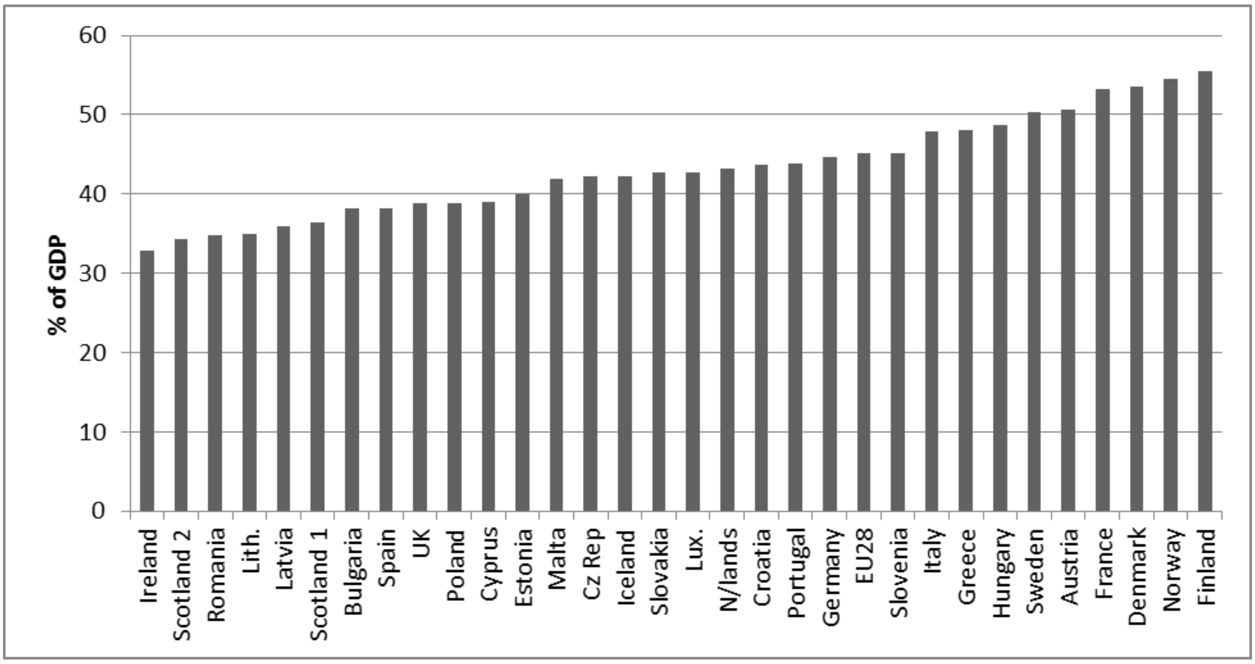
[1] OECD 2012, "Income inequality and growth: the role of taxes and transfers", OECD Economics Department Policy Notes, No.9 January 2012

Chart 1 Total Tax Revenues as a percentage of GDP, average from 2004-2015



Source: Eurostat Tax Database; GERS, August 2016 (Scotland 1 is Scotland including North Sea revenue; Scotland 2 is excluding North Sea revenue)

Chart 2 Total Tax Revenues as a percentage of GDP, 2015

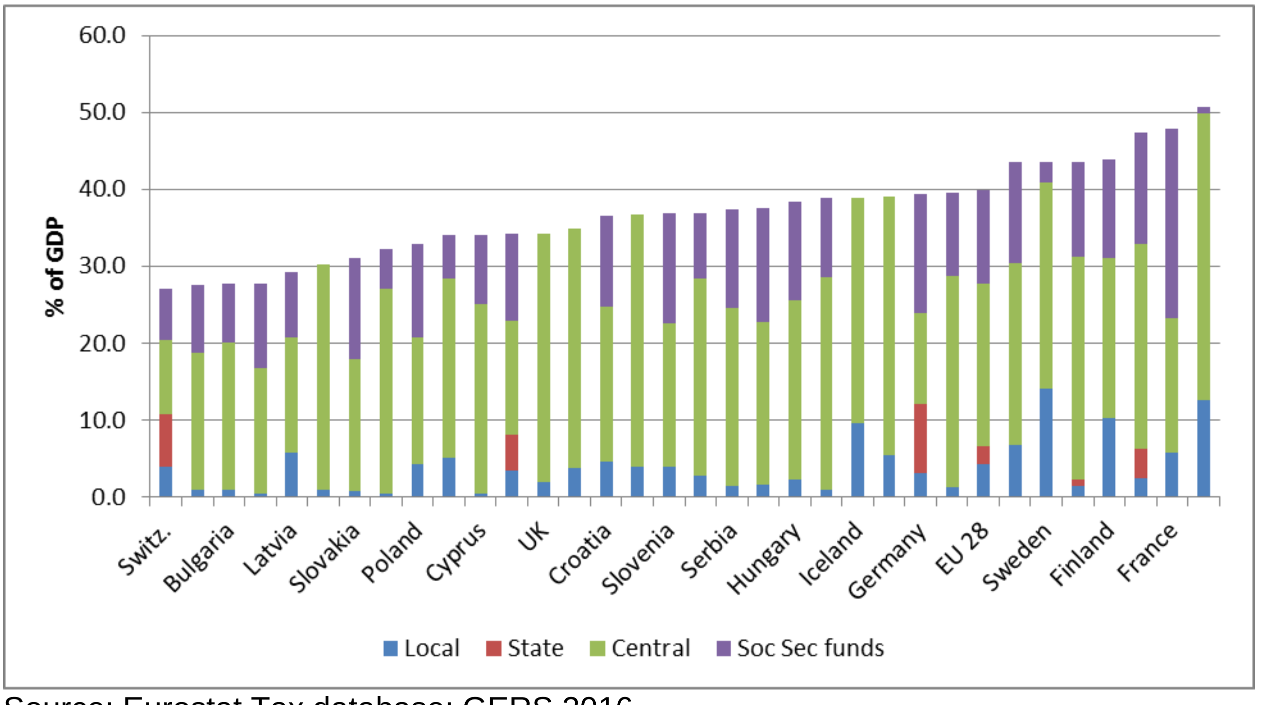


Sources: as for Chart 1 above (no information available for Switzerland)

2.9 **Distribution** – the tax system should aim to achieve a more equal distribution of household income. This necessitates a forensic approach to quantifying in advance the distributional consequences of tax changes and a willingness to challenge prevailing orthodoxies. For example, despite the widespread support for recent UK measures, raising the personal allowance is an expensive and poorly targeted measure if reducing inequality is the goal. It distributes the majority of the benefits to those in the upper half of the household income distribution and fails to assist the very poorest who don't pay income tax. Also, the mechanisms by which tax policy affects distribution might not always be obvious; a higher top rate of tax is likely to reduce inequality not primarily through the redistribution of the revenues collected but by changing incentives for the top one per cent to bargain in their own interests (see below).

2.10 **Devolution/local taxes** – the data suggests that those nations which collect more tax at a local level, consistently manage to collect higher TTRs. Scotland and the UK are heavily centralised in this respect: in 2012 (the latest year for which Eurostat has published data) local taxes in the UK accounted for only 4.8% of TTRs. Denmark collected 26.9% of TTRs locally; Sweden 34.9% and the EU28 average was 11%.

Chart 3 Total tax revenues by level of Government, 2015



Source: Eurostat Tax database; GERS 2016

2.11 Building on the work of the Commission for Strengthening Local Democracy, it is necessary to devolve tax powers within Scotland. The Council Tax can be easily and quickly reformed to improve progressivity while the many serious options for its replacement are (re)considered. It is essential that a property tax element should be retained. Local Authorities should have greater discretion to introduce taxes to meet local circumstances and needs (e.g. tourism taxes).

2.12 **Indirect effects**: generating sufficient total revenue may be the main purpose of the tax system but it isn't the only one. Taxes can influence behaviours in important ways. It's worth noting that all the Nordic nations have a higher top rate of income tax and that these rates apply at a much lower threshold than the UK's (lower) top rate[2]. This is significant not because it reflects the progressivity of their *systems as a whole* but rather that it points to a recognition that high marginal tax rates may have indirect effects, especially on corporate behaviour that are socially valuable. There is no correlation between cuts in the top tax rate and economic growth but there is a very strong correlation between cuts in the top tax rate and rising *pre-tax* income: the UK and US have over the past forty years implemented some of the largest cuts in the top rate of tax yet experienced comparatively moderate growth. Both have however witnessed some of the largest increases in pre-tax incomes of the top 1%[3].

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

2.13 For most workers using PAYE the system has generally been efficient, providing convenience/ease of payment and a reasonable degree of certainty. However, the ongoing attack on HMRC resources is undoubtedly having a hugely adverse impact on both efficiency and convenience. The closure of HMRC enquiry centres means it is very difficult to access face to face advice and understaffing leads to lengthy waits when trying to access online services. *The STUC would encourage the Committee to pay particular attention to the submission of the Public and Commercial Services Union (PCS) in this regard*.

2.14 The current system is also insufficiently proportionate to the ability to pay; Income Tax and the Council Tax could certainly be more progressive. The Scottish Government's proposals for Income Tax are worryingly timid and based on a narrow reading of flawed evidence.

2.15 There has been scant indication that the Scottish Government is treating taxation as a coherent system – its approach has been piecemeal and bereft of compelling evidence. Its response to the Commission on Local Taxation was especially disappointing.

---

[2] See Annex 1

[3] See for instance: *The Top 1% in International and Historical Perspective,* Alvaredo, Atkinson, Piketty and Saez, Journal of Economic Perspectives Vol 27 No. 3 Summer 2013

Is there scope for a fundamentally different approach to taxation in Scotland?

2.16 Yes, although it is important to acknowledge that, even with the new powers accruing in 2017, the Scottish Government will have greater but not full control of taxation. As mentioned above, the degree of integration with the rUK labour market could constrain Scottish tax policy although the STUC believes the extent to which this is likely to be the case is already being exaggerated.

2.17 Over time, there is no reason why a distinct Scottish system should not emerge. Knowledge on the durability and elasticity of the Scottish tax base will accumulate over time, better informing the introduction of new measures.

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

2.18 The STUC is sceptical about hypothecated taxation – it is essential that the funding of essential public services isn't too dependent on highly cyclical tax revenues. How taxes are raised is an entirely different issue to how revenues are ultimately spent and it is unhelpful to conflate the two. Developing a distinct system on the assumption that there can be a direct relationship between how much we tax one activity and how much we spend on one activity will be profoundly problematic and risk subjecting essential services with constant/growing demand to fluctuating receipts.

To what extent do potential behavioural responses limit options for tax changes in Scotland?

2.19 Assessing potential behavioural responses must be an integral part of the tax policy process. There is no point developing policies which fail to produce expected outcomes because of unforeseen responses of individuals or firms. It might sometimes be difficult to predict the scale of the behavioural response to tax changes but it is sensible to treat negative responses as a risk.

2.20 Behavioural responses may also have a more acute impact in Scotland given that the labour market remains highly integrated with the UK (though, as the Bank of England highlighted during the referendum campaign – labour mobility between Scotland and England is significantly lower than between American, Australian and Canadian states though higher than between EU countries)[4].

2.21 However, the assessment of behavioural responses cannot simply be limited to the narrow locational responses of firms and high earning individuals to higher taxes. All potential behaviours must be considered.

---

[4] The Economics of Currency Unions, speech delivered by Mark Carney, Governor of the Bank of England, January 2014

2.22 Consider again the example of increasing the top rate of income tax. Earlier this year, the Scottish Government published analysis which suggested a higher top rate in Scotland could result in low or even negative yields due to the behavioural response of high earners i.e. individuals would relocate due to the prospect or impact of a higher top rate. But this narrow analysis didn't encompass the occupational mix of Scotland's top rate tax payers or the potential for these jobs to be relocated. If a significantly higher proportion of Scotland's top rate earners are in the public sector, then the risk of the tax revenues being lost must be very low. Individual workers may choose to depart for lower tax jurisdictions (although the evidence for this is scant) but the process by which the tax liability is assumed to be lost is far from obvious – the posts will be filled by new workers paying similar rates of tax.

Questions 6 and 7

2.23 Again, the STUC encourages the Committee to pay particular attention to the PCS submission. The workers currently administering the tax regime are best placed to comment on operational issues.

2.24 However it is important to stress that any effective system must be adequately staffed and resourced. It is no accident that evasion and avoidance activities seem to be closely associated with the decline in the HMRC workforce. Indeed, some activities – especially large company taxation – have for some years been massively under resourced at UK level.

STUC
September 2016

Annex 1

Year	2015					
Income Tax	Top marginal tax rates		Top statutory personal income tax rates		Average wage in national currency units	Average wage in US dollars based on Purchasing Power Parities
	Personal income tax	Personal income tax & employee social security contributions (All-in rate)	Top tax rates	Threshold (expressed as a multiple of the average wage)		
Country						
Australia	49.0	49.0	49.0	2.2	80,774.0	55,921.2
Austria	50.0	50.0	50.0	13.7	43,483.8	53,564.5
Belgium	45.3	58.4	53.8	1.0	46,692.9	57,166.4
Canada	49.5	49.5	49.5	4.3	50,877.3	41,719.3
Chile	40.0	40.0	40.0	11.3	7,556,043.0	19,337.8
Czech Republic	20.1	31.1	15.0	0.4	317,923.7	24,481.6
Denmark	55.8	55.8	55.8	1.2	405,875.8	54,012.7
Estonia	19.7	21.3	20.0	0.1	12,925.6	24,009.6
Finland	49.1	57.5	51.6	2.2	43,536.2	47,503.3
France	54.0	55.0	54.5	14.8	37,792.2	46,103.1
Germany	47.5	47.5	47.5	5.5	47,041.9	59,986.5
Greece	50.0	50.0	50.0	25.2	20,296.5	34,265.7
Hungary	16.0	34.5	16.0	0.0	3,172,121.7	24,307.9
Iceland	44.4	44.4	46.2	1.4	7,440,480.3	51,181.1
Ireland	47.0	51.0	47.0	1.0	34,847.2	41,053.7
Israel	50.0	50.0	50.0	5.9	137,958.2	34,240.5
Italy	48.8	48.8	50.1	9.8	30,710.1	41,250.4
Japan	55.7	56.2	55.9	8.9	5,005,806.5	47,205.3
Korea	39.3	43.2	41.8	4.2	42,162,723.4	47,286.4
Luxembourg	43.6	45.5	43.6	2.9	55,552.7	60,811.9
Mexico	35.0	35.0	35.0	28.4	105,924.1	12,865.4
Netherlands	49.2	52.1	52.0	1.2	49,235.0	60,867.0
New Zealand	33.0	33.0	33.0	1.2	56,110.0	39,493.0
Norway	39.0	47.2	39.0	1.6	552,012.4	60,203.5
Poland	20.9	38.8	32.0	2.2	45,521.4	25,637.0
Portugal	50.3	61.3	56.5	16.3	17,279.9	29,691.9
Slovak Republic	21.7	35.1	25.0	3.8	10,616.4	21,764.5
Slovenia	39.0	61.1	50.0	5.3	18,108.8	30,660.1
Spain	46.0	46.0	46.0	2.5	26,259.5	39,529.2
Sweden	57.0	57.0	57.0	1.5	421,363.9	46,678.3
Switzerland	36.1	41.7	41.7	3.3	90,286.1	69,886.8
Turkey	35.8	35.8	35.8	3.8	32,048.0	25,926.3
United Kingdom	45.0	47.0	45.0	4.2	36,016.6	51,430.5
United States	46.3	48.6	46.3	8.2	50,963.8	50,963.8

Source: OECD Tax database