SCOTLAND’S BUDGET 2019

TAXATION – GROWING DIVERGENCE?

1. The Scotland Act of 2016 has brought significant tax devolution to Scotland. And only a few years in, there is growing divergence between Scottish and UK income tax policies. This chapter asks whether Scotland will continue to set its own path – or will UK tax measures, and the potential for radical ‘Brexit’ tax proposals, cast a shadow over the forthcoming Scottish budget? There is also the question of whether a Scottish budget can be fully considered if the UK budget proposals are not known.

Income tax

2. The largest source of tax revenue in Scotland is income tax where the distinctiveness of Scottish income tax policy is illustrated by the range of tax bands and rates. The direction of travel was set in 2018/19 with the introduction of five bands – providing a more progressive charging structure than in the rest of the UK. With this structure, the profile of Scottish income tax has been raised as the differentials between Scotland and the rest of the UK have grown across thresholds and rates, and from one year to another. The Scottish Government may choose to stay with this income tax structure; however, possible behavioural reactions to increasing costs for higher earners, relative to those in the rest of the UK, will need to be factored into decision making. UK decisions may increase the tensions.

3. Across the UK, the self-employed have always had the choice of operating as a sole trader or partnership (liable to income tax) or via a company (liable to corporation tax, whilst the owner may reward themselves by way of salary and/or dividends liable to income tax). A number of factors can influence this choice, including limited liability, tax and pension provision.

4. The tax differential for the Scottish taxpayer may be up to around £4,000 depending on the level of profits up to £100,000 and how funds are extracted from the company. For the smaller business, the interaction between Scottish and UK tax regimes may encourage incorporation by Scottish taxpayers at an earlier stage in the business’s evolution than compared to those in the rest of the UK.

5. This decision around the form of trading entity adopted not only influences the amount of tax payable by the trader but also determines which jurisdiction receives the taxes paid. Corporation tax is payable to the UK Exchequer, as is income tax on dividends. Scotland will only directly receive funds from Scottish income tax levied on non-savings, non-dividend income (earnings).

6. For the individual Scottish taxpayer, Scottish income tax rates, determined by the Scottish Government, will be factors to consider; as will the UK corporation tax rate, determined by Westminster. The corporation tax rate is currently set to reduce to 17% but post Brexit this could change.

7. Under existing rules, HMRC does not have sufficient resource to police all one-man companies; however incoming ‘IR35’ rules put the onus on the ‘employing’ company, which may lead to more conservative decisions, and lead to more contractors being within payroll. This would benefit the Scottish Exchequer and would help prevent incorporations of disguised employees.

The tax base- how many will pay income tax?

8. The UK Government has direct influence over the amount of Scottish income tax available to the Scottish Government. The personal allowance is set by Westminster and applies to all UK taxpayers, with the effect that significant numbers of the Scottish population are lifted out of income tax altogether (44.6% in 2019/20\(^1\)), reducing the size of the Scottish taxpaying base.

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9. There are 2.5 million income taxpayers in Scotland and the average annual salary is estimated to be £25,000. In 2019/20, 7.7% of Scottish adults (351,000 in absolute numbers) were expected to pay higher rate of income tax at 41% - compared to 40% in the rest of the UK (rUK) - and 16,000 adults (0.3%) the top 46p rate. There are not that many, and it is desirable to attract more higher rate and additional rate jobs and job holders to Scotland which may prove difficult if further divergence arises.

10. Whilst many believe in a more progressive income tax system there are tensions and challenges arising from the size, shape and potential mobility of the Scottish income tax base, which need to be factored in when developing tax policy, particularly if there is increasing divergence from the rest of the UK.

11. The tensions inherent in a more progressive tax system are potentially threefold: the desire to encourage inward migration and discourage outward migration; whilst there may also be exposure to electoral punishment. The first two are risks to the Scottish budget. The latter would be the case if the Scottish Government policy does not align sufficiently with the higher earning portion of the electorate’s wishes.

Is National Insurance tax?

12. Divergence in income tax rates has led to a costly National Insurance (NIC) problem for middle earners in Scotland, which may be exacerbated if higher rate thresholds diverge further. One may wonder why changes in income tax affect NIC but for some years now, legislative provisions have ensured that the upper NIC threshold mirrors the rUK income tax higher rate threshold.

13. It is a matter that goes virtually unnoticed but in the rest of the UK if the 20% band is extended, so is NIC at 12%; less income tax may be collected, whilst more NIC is payable.

14. In Scotland, in 2019/20, those who earn amounts between the Scottish threshold of £43,430 and the UK threshold of £50,000 pay income tax at 41% and NIC at 12% - each pound earned in this bracket is subject to ‘payroll taxes’ totalling 53%. This is an expensive marginal rate, which taxpayers may seek to minimise through behavioural change.

15. It is difficult to quantify attempts 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 further holiday entitlement; or individuals may increase their pension contributions, reduce their hours or not take on overtime and hence reduce their taxable pay. Small changes for individuals, but the cumulative effect could be significant for the Scottish Government in terms of tax take and in terms of productivity with both fiscal and economic impact.

16. Scotland has set a distinctive path for itself in its Scottish income tax measures but in a tax regime where income tax is partially devolved, the rUK measures – both tax and NIC - will also have a significant impact. The Scottish Government will have difficult decisions to make if it wants to raise funds, maintain divergent policies, and keep Scottish income taxpayers on board. These decisions are also made more difficult if the UK tax proposals for 2010/21 are unknown.

Land and Buildings Transaction Tax (LBTT)

17. When LBTT was introduced in Scotland in 2015 there was an innovative move away from the UK SDLT slab system. However, only a few years on, the rUK and Scottish land taxes are both on a ‘progressive’ basis. Each jurisdiction has also introduced a surcharge on the purchase of additional residential properties, and the policy measures seem to be converging.

18. Where there is visible divergence is in the rates charged – both for residential and non-residential property.

19. It remains to be seen whether the Scottish Government will maintain these distinctive rates or whether pressures to reduce property taxes will have an effect in the future.

\(^2\) As in footnote 1 above
20. It also remains to be seen whether policies may again become more distinctive. For example, there is a UK proposal to introduce a non-resident surcharge, although this is currently on hold. Should such a measure be introduced in England, would the devolved jurisdictions do likewise? Or has Scotland already partially addressed this by increasing the Additional Dwelling Supplement to 4% in January 2019?

New taxes – fund raising or behaviour management?

21. The Scotland Act 2016 provides that Scotland can introduce new taxes. These would allow Scotland – or its local authorities - to introduce new taxes and the most recent Scottish budget saw late amendments to allow for a Transient Visitor Levy (TVL, more commonly referred to as a ‘tourist tax’) and a workplace parking levy.

22. A constraint on the proposed new taxes is that the amounts involved are relatively small, but they can add to burdens on business. Also, some of the new tax options being discussed are designed to drive behaviour change, rather than primarily to raise revenues.

23. Further analysis is required before considering other new taxes, along with some of the issues such as who will receive the money (the Scottish Government, or local authorities), and whether it might be ringfenced towards certain expenditures. There is also the consideration that if the aim is to change behaviour and it is successful, the authorities may not get much, if any, revenues. It is a complex matrix.

Unwanted devolved taxes?

24. Questions remain around the devolved powers in the Scotland Act 2016 that have not yet been fully implemented, although the Scottish Government has gone some way towards doing so.

25. The Air Departure Tax (Scotland) Act 2017 received Royal Assent on 25 July 2017, but implementation remains on hold due to EU state aid issues. With the shape of Brexit unknown at the time of writing, it is not clear whether, or when, issues around state aid will be resolved and the new ADT introduced. The Scottish Government has said, however, that due to climate change concerns it no longer intends to reduce the rates of tax when it is introduced, thereby removing much of its distinctiveness. It is also interesting to note that the UK Government has recently said it will not devolve Air Passenger Duty to Wales because competition on rates would be likely to damage nearby English airports. Clearly, divergent policies may not be helpful.

26. One major source of ‘devolved’ tax revenue that was recommended by the Smith Commission, and provided for in the Scotland Act 2016, was the assignment of a proportion of Scottish VAT to Scotland. The underlying aim was to align tax revenues with the performance of the economy but, despite much negotiation, a satisfactory methodology has yet to be identified.

27. VAT assignment does not bring the scope for any distinctiveness or divergence to Scottish tax policy; nor can it be clearly linked to the Scottish Government’s economic policy – and it is a moot point as to whether VAT assignment brings any benefits to either government (UK or Scottish).

Policy making

28. Something which has been innovative is a new Scottish Government policy-making approach to taxation. A new and, in our view, successful process was used in November 2017 when the Scottish Government issued a paper, ‘The role of Income tax In Scotland’s Budget’, prior to the Scottish Budget. This set out a number of options for exercising income tax powers and was followed by a series of round table discussions. This was a most constructive and helpful exercise, which helped to pave the way for the introduction of the new structure for Scottish income tax, with the five rates and bands. By contrast, the unexpected late amendments to last year’s budget relating to the new tourist tax and the workplace parking levy (which were added without prior consultation), were unfavourably received.
29. The Scottish Government has been consulting about its tax policy making and seems likely to adopt a more collaborative approach than in the rest of the UK. This is welcome.

**Positive messaging**

30. In the main, tax is seen as a cost by both businesses and individuals in any evaluation of whether Scotland is an attractive location. To inform taxpayers’ decision making there should be clear explanations of how the various ‘Scottish taxes’ work and how they link to public expenditure as well as other factors tied to locating in Scotland. There is also a need to consider the cumulative effect on individuals and businesses of the different taxes, such as income tax, council tax, business rates and LBTT.

31. It is important that existing Scottish taxpayers understand and support their contribution to public finances; it is equally important that those who may wish to move to Scotland understand the purpose of Scottish taxation policy, the relationship between tax and public spending and the benefit that Scottish taxpayers enjoy from that public spending and different policies. The Scottish Government is currently considering a public education campaign to raise awareness of Scottish taxes and their role, which is helpful.

**In summary**

32. The Scottish Government has established, in a short space of time, a distinctive tax regime but it is one which is intertwined with the UK tax system. Hence, there are considerable constraints which are in part due to the politics that any government faces, and in part due to the intertwining of the Scottish and UK tax systems so that Scotland only has access to some of the fiscal levers.

33. It is not yet clear either how measures in the 2019 UK Budget (for example any decision to increase the personal allowance or the higher rate threshold) may affect the Cabinet Secretary’s ability to maintain, or increase, the divergence of Scottish taxation in the next Scottish Budget.

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The ICAS role

ICAS (The Institute of Chartered Accountants of Scotland) is the oldest professional body of accountants. We represent over 22,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK or in almost 100 countries around the world.

ICAS has a public interest remit – a duty to act not only for its members but for the wider public good. Our technical experts work in a positive and constructive manner to advise policy makers on legislation and to raise issues of importance to our members, individual taxpayers and business alike.

Taxation is one such area of importance and ICAS has contributed, and will continue to contribute, to tax policy in Scotland, the UK and beyond.

The Scottish Taxes Committee’s objectives in discussing Scotland’s budget are to:

- act in the public interest
- provide constructive input to the authorities, and
- represent ICAS members and students’ interests.