A DYNAMIC SCOTLAND: THE ROLE OF COMPETITIVE AND FAIR TAXES

Final Report of the Independent Commission for Competitive and Fair Taxation in Scotland

January 2016

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1. CHAIRMAN'S FOREWORD

In the run-up to the 2014 referendum on independence, all of Scotland's main political parties promised more devolved powers for the Scottish Parliament in the event of a No vote. Lord Smith of Kelvin KT was invited to chair a Commission of representatives of five of Scotland's political parties in order to reach agreement on which further powers should be devolved. Agreement was reached and the Smith Commission's report was published in November 2014. Smith's recommendations, where legislation is required, are now reflected in the Scotland Bill currently making its passage through the UK Parliament.

Although the Smith Commission's recommendations extend beyond matters of taxation, it is the Scottish Parliament's new powers to set various taxes that stand out. When the tax provisions in the Scotland Bill are fully in place from April 2017, around 50% of Scotland's block grant will be replaced with a mix of taxes set by the Scottish Parliament and ten points of UK VAT assigned to the Scottish Consolidated Fund. This will be a major change for the Parliament in that its responsibility will increase from one of determining how its block grant funding, calculated under the Barnett Formula, should be spent to one of judging how much money to raise in taxes and borrowing in support of its spending and other objectives. To a large extent the Scottish Parliament to date has been sheltered by the Barnett Formula from the tough political decisions that are necessary to balance the imposition of taxes on Scottish taxpayers on the one hand with public spending on the electorate's behalf on the other. But these days will come to an end in April 2017.

Decisions on tax will impact on more than just public spending. Taxes will need to be set in line with the electorate's mandate, be fair and promote Scotland's economic competitiveness. So, I was delighted when Ruth Davidson MSP, Leader of the Scottish Conservatives, invited me to chair a new and independent commission to examine how best the Scottish Parliament should use its existing and new tax powers to boost Scotland's economic growth. From now on the debate in Scotland needs to include tax as well as matters concerned with spending and I thank and pay tribute to Ms Davidson for her forward-looking decision to propose the setting up of the Commission. I hope very much that this report will stimulate a rigorous debate on Scotland's international competitiveness and the contribution that competitive and fair taxes can make to improving Scotland's economy.

It has been a pleasure and a privilege for me to have chaired the Independent Commission for Competitive and Fair Taxation in Scotland. I would like to thank those organisations and individuals who submitted written evidence and those with whom we engaged in oral evidence sessions. I also give thanks to my fellow commissioners and our secretary. I have appreciated at all times their wonderful mix of knowledge, skills and experience as well as the collegiate, constructive and good humoured way in which they have supported me as their Chairman. I couldn't have wished for a better team.

SIR IAIN McMILLAN CBE
Chairman
The Independent Commission for Competitive and Fair Taxation in Scotland
25th January 2016

2. COMMISSION REMIT & MEMBERSHIP

The Independent Commission for Competitive and Fair Taxation in Scotland was established in February 2015 following the publication of the Scotland Bill draft clauses. The suggested brief for the Commission was to examine how best the Scottish Parliament should use its existing and new tax powers to boost economic growth in Scotland, and make broad recommendations on public sector spending so Scotland can have a competitive and fair tax system and the funding to support vital public services.

The Commission has agreed that its remit is encapsulated in the following question we sought to answer:

"How can existing and post-Smith powers best be used to promote Scotland's economy and competitiveness, while ensuring strong and sustainable public services and a regime which is fair to the taxpayer?"

While it was the Scottish Conservative and Unionist Party that decided to set up a tax commission, those who were approached to be Commissioners unanimously insisted that it must not be subject to political direction or control. The Commission is answerable only to the public. We were therefore pleased that Rt. Hon. Professor Sir David Edward KCMG QC FRSE, a former Judge of the Court of Justice of the European Union, agreed to act as an independent "scrutineer" of the Commission's work. The Commission was also fortunate to be able to draw on the advice of Professor Arthur Midwinter, whose expertise in public finance provided invaluable insight into some of the issues we discussed throughout our work, assisting in an evidence-led process. It should be noted that Sir David and Professor Midwinter are not members of the Commission and our conclusions and recommendations should not be attributed to them.

The Commissioners themselves were approached due to their expertise and experience in their individual fields. The resulting make-up of the Commission allowed for an expert analysis of the evidence we received, robust discussions in our meetings and a balanced approach to the recommendations we make.

Sir Iain McMillan CBE (Commission Chairman)

Sir Iain McMillan is one of Scotland's most respected public figures, retiring from his post as Director of CBI Scotland in 2014 after holding the key business post for nearly twenty years.

He is the author and co-author of a number of publications on public policy relating to business and economics.

He is also chairman of the University of Strathclyde Business School's Advisory Board, chairman of Work Place Chaplaincy Scotland, board member and UK representative of the British American Business Council, a trustee of The Carnegie Trust for the Universities of Scotland, and in 2009, he was appointed by Her Majesty the Queen to be Honorary Air Commodore of 602 (City of Glasgow) Squadron, Royal Auxiliary Air Force.

Sir Iain was educated at Bearsden Academy and is a Fellow of the Chartered Institute of Bankers; Fellow of the Chartered Institute of Bankers in Scotland; Fellow of the Association of International Accountants; Companion of the Chartered Management Institute; Fellow of the Royal Society of Arts; and Fellow of the Scottish Qualifications Authority. In 2003, he was awarded the CBE for services to lifelong learning in Scotland. In 2015, he was knighted for services to the Scottish economy.

Bill Jamieson

Bill Jamieson was executive editor of The Scotsman for 11 years, regularly writing about finance, economics, politics and current affairs. He was also the economics columnist for sister title Scotland on Sunday and prior to that was economics editor of The Sunday Telegraph for seven years.

He has been a regular contributor to the Spectator Business magazine and City AM and frequently commentates on business and economics affairs for BBC Scotland. In 2009 he won both Business Journalist of the Year and Journalist of the Year at the Scottish Press Awards British Economy and Scotland's Ten Tomorrows. He collected Campaign of the Year Award for The Scotsman for its series of articles on the Lloyds-HBOS merger. Since stepping down from The Scotsman, he has established Scott-Buzz, the one-stop business news website aiming provide a daily update and comment on Scottish economic and business data.

Rhona Irving

Rhona Irving is a tax professional who qualified with the Chartered Institute of Taxation. She was a tax partner at PwC until her retirement last year. During her time at PwC she advised a range of businesses from small start-ups to major international businesses.

She also ran the Scottish tax practice of PwC and had responsibility for education and learning for the national UK tax practice. Rhona was also a member of the ICAS International Taxes Committee and sat on the Council of CBI Scotland. Rhona chairs the board of the School for Social Entrepreneurs in Scotland

Jack Perry CBE CA

Jack Perry is an independent non-executive board member and chairman of a number of public and private companies. He previously served as Chief Executive of Scottish Enterprise, for six years until November 2009.

Prior to this, until December 2003, he was the managing partner of Ernst & Young LLP in Glasgow. In addition he was Regional Industry Leader for Technology & Communications and Consumer Products. Jack is a past Chairman of the Confederation of British Industry (CBI) Scotland.

He is Chairman of ICG-Longbow Senior Debt Investments Ltd, Chairman of European Assets Trust NV, and Chairman of the Scottish Aquaculture Innovation Centre (SAIC). Jack is also Chairman of Hospice Developments Limited and Treasurer of the University of Strathclyde.

Anthony Rush

Anthony ("Tony") Rush served for over 30 years in Senior Executive posts in Scottish Industry until his retirement in 2013. He is most remembered as being parachuted in as chairman of ailing construction group Barr Ltd, the Paisley-based construction company. A lesser known part of his career is the work he has done advising public bodies on large infrastructure projects.

Throughout his career Anthony served two terms as Chairman of the minerals trade body in Scotland and represented the Construction industry through the FCEC. He has also served as a Member of his Local Area Committee and Community Planning Board.

He served several terms as a Council Member of CBI Scotland and was recognised by that body for his knowledge and expertise in infrastructure, planning, government spending and renewable energy. He also has a life-time experience of house building in the UK and of hands-on investment.

Dr Andrew Lilico

Andrew Lilico is an economist with Europe Economics, and chairman of the IEA Shadow Monetary Policy Committee. He's also been a mathematical chemist, an opera singer, a philosopher and computer programmer. One of Europe's top experts on the economic impact of financial regulation, he led the teams doing the European Parliament's assessment of the impact of the Financial Services Action Plan, the European Commission's assessment of the costs of complying with financial regulation, and the Financial Service Authority's assessment of the benefits of the Markets in Financial Instruments Directive. He is a regular commentator on economic issues on BBC television and radio, and on Sky, Bloomberg and CNBC Europe.

Paul Sinclair

Paul Sinclair is a former special adviser to Prime Minister Gordon Brown, Douglas Alexander and former Scottish Labour leader Johann Lamont. He was recently also senior adviser to Alistair Darling of the Better Together campaign in the Scottish referendum.

To trade he is a journalist who worked in print and broadcast who was latterly Political Editor of the Daily Record and a member of the lobby at Westminster and at Holyrood.

Paul now works as a strategic communications consultant and speechwriter.

Professor Arthur Midwinter (adviser to the Commission)

Arthur Midwinter is an emeritus professor of the University of Strathclyde, and an associate professor in the Institute of Public Sector Accounting Research in Edinburgh Business School. He has been a consultant to a range of local authorities and health boards in Scotland, and was a member of the Local Government Staff Commission in Scotland from 1994 to 1997. He was an expert adviser to the Arbuthnott Report on Health Service Resource Allocation. From 2002 to 2007, he was budget adviser to the Scottish Parliament and from 2007 to March 2011 he was an advisor to the Scottish Parliamentary Labour Group.

3. EXECUTIVE SUMMARY

Simplicity and transparency must be the key in designing new taxes and reforming existing ones, with administration costs minimised.

While the increased tax raising powers for the Scottish Parliament present opportunities they also present risks and weaken the safety net of the Barnett Formula.

Scotland's overall tax burden should not be higher than in any other part of the United Kingdom and lower when affordable.

On Income Tax:

- The system should be progressive and smoother with the introduction of a new band between the 20% and 40% bands.
- The aim of the income tax system should be to retain and attract a skilled workforce.
- The top rate of income tax should not be higher than in any other part of the United Kingdom.

On the Council Tax:

- The Council Tax should be reformed into a fairer, more local and progressive tax with reliefs aimed at low income households across the bands.
- The Council Tax freeze should end and the banding structure reformed.

On the Land and Buildings Transaction Tax:

- Residential LBTT is both uncompetitive and unfair. In the long term it should be abolished. In the short term it should be made into a flatter charge.
- Commercial LBTT should be devolved to a form of regional authorities with the freedom to design their own bands, thresholds and rates.

On Air Passenger Duty:

- APD should be replaced with a competitive Departure Tax, with a more progressive structure linked to travel distance.

On Business Rates:

- Business Rates should be frozen at least until the end of the next Parliament and reliefs reformed to encourage employment and investment.

On Governance:

- The Scottish Government should exercise a more rigorous and transparent approach to budget reporting and Whole of Government Accounts for Scotland should be compiled, kept up to date and made easily accessible.

4. THE WORK OF THE COMMISSION

The Independent Commission for Fair and Competitive Taxation first met in plenary session in March 2015 and further plenary meetings were held in Glasgow or Edinburgh on a monthly basis. These were interspersed by smaller meetings between Commissioners on specific topics.

We issued our Call for Evidence on 15 June 2015, with a deadline for submissions set for 31 July 2015. Written evidence was collected and published online at www.comtax.org, although we did respect the call for privacy from those who indicated it.

We analysed written evidence and followed up on it in a series of oral evidence sessions held in September and October. Individual Commissioners also held private meetings with stakeholders to tease out detailed views on some specific issues we wanted to explore.

The evidence we received, both in writing and orally, formed the basis of this report. In addition to the evidence, we have extensively researched issues within our remit and have drawn on multiple sources of data, as referenced, all of which are publicly available.

The final report and its recommendations is presented as an agreed document amongst the members of the Commission following our deliberations over the best part of a year.

5. KEY PRINCIPLES

We have received submissions from a good range of organisations as well as individuals, some made public and others kept private on request. We were pleasantly surprised to see a level of agreement throughout this process on some of the most fundamental of issues.

Throughout the Commission's deliberations - and the analysis of evidence received - a few recurring themes emerged. In advance of the final drafting of this report, we have therefore discussed and agreed five key principles which should be applied to policy decisions in order to achieve what this Commission was asked to report on – a competitive and fair taxation system in Scotland.

The very definitions of "competitive" and "fair", however, lie at the heart of what the Commission examined. The definition of the former is considerably easier – competitive in our view means being as good as or better than something of a comparable nature. In the context of our work we take it broadly to mean the Scottish tax system not putting individuals and businesses at a disadvantage vis-à-vis our closest competitors. Moreover it should be designed to attract the skills and investment required to build the economy to support a fair society through fair taxation revenues.

The concept of "fairness", however, was just as important to our work. In defining fairness, we draw on Andrew Lilico's essay on this topic [1], which successfully captures the malleability of the term. In his work being fair is "a special kind of being proportionate", with particular application in respect of equality (e.g. to be treated equally regardless personal circumstance), proportionality (e.g. fair is to pay tax proportional to the ability to pay) and desert (e.g. fair is to receive rewards proportionate to your efforts).

These twin concepts of competitiveness and fairness underpin this report. We believe our recommendations demonstrate that they are not contradictory concepts, but can and in fact should be complementary.

We have identified the following key principles which should guide the approach to a competitive and fair system of taxation. It should be:

- Simple
- Progressive
- Incentivising
- Local
- Transparent

1. Simple

We believe that a key principle in designing Scotland's future tax system – be it around new or existing fiscal powers – must be simplicity. Some complexity will be unavoidable due to the mix of constitutional powers (e.g. on income tax). But complex tax designs with multiple networks of different rates, tiers, thresholds, allowances, reliefs or exemptions that are lacking in transparency are liable to produce results that are inherently unfair to those who cannot afford expert advice and assistance. They should be avoided as far as practicable.

2. Progressive

Simplicity, however, has to be balanced out by a degree of progressiveness. While we believe that the tax burden should be spread relatively evenly, it should be broadly related to the ability to pay. We have identified above that "fairness" as a concept is flexible, but proportionality is a crucial part of its definition. Disproportionately low levels of taxation for high earners are just as unfair as disproportionately high ones. In deciding where to strike the balance, we kept fairness as well as competitiveness in mind.

3. Incentivising

The devolution of tax powers within a single UK market presents challenges as well as opportunities. We believe that decisions to vary taxation in Scotland should assess the impact on both the movement of people and goods and the ability to do business across the UK. Moreover, Scotland's position on the geographic periphery can be an inherent logistical disadvantage to exporters compared with our EU competitors and our tax system should reflect that. Taxation will always play only a part in this, but policymakers should keep Scotland's attractiveness as a place to live, to work and to do business vis-à-vis our closest competitors in mind.

1 Andrew Lilico, On Fairness, Policy Exchange Research Paper, February 2011

4. Local

The erosion of local autonomy in Scotland has been highlighted throughout the consultation responses. The taxation powers currently and soon-to-be held in Scotland should be designed around local accountability. But many of the services that local government delivers are mandated by the Scottish Government who should fund local government accordingly and in line with strategic plans. This has to be done in a balanced way, so that all tiers of government have the powers necessary to implement their policies.

5. Transparent

The relationship between elected representatives and the people they represent depends on transparency – in other words, making the work of government readily understandable for the average citizen. This principle applies to public spending as well as taxation, and we believe that greater progress is needed in both areas. If the constitutional debate of the last few years has exposed anything, it has been the lack of information about the exercise of fiscal and non-fiscal powers in Scotland. How well the Scottish Parliament uses its powers will be assisted by independent scrutiny of data, budgets, development plans and how it applies its tax and welfare powers.

6. THE SCOTTISH ECONOMY

6.1 Background

Scotland's economic performance has, over the past few years, been looked at relative to the performance of the UK economy. Scotland's performance, positive or negative, vis-à-vis the rest of the United Kingdom on a range of economic indicators – GDP per capita, employment, business growth – has been used to further political arguments on the constitutional arrangements of the UK.

It is not the role of our Commission to engage in this debate. Our recommendations are based on an objective assessment of the powers at the disposal to the Scottish Government. They are not a normative judgment as to where powers should be allocated in a UK context.

There has been little clarity as to what economic levers are available to the Scottish Government and their potential to impact on the Scottish economy. For most of the 17 years since devolution Scottish political attention has centred on spending choices made by the Scottish Government and Parliament. The 2012 and 2016 Scotland Acts will allow us to move on to different ground by significantly increasing the fiscal accountability of the Scottish Parliament. We believe this is a welcome development.

This report considers the current and future powers in relation to regional economic development in Scotland, couched within the broader economic performance of the UK which is, in turn, tied to global economic trends.

Whilst our recommendations focus primarily on taxation, we cannot ignore other areas of Scottish public policy that we feel have an impact on the delivery of our identified priorities. The spending, regulatory and borrowing powers we address in this report are in no way exhaustive. We have deliberately focused on those we deemed most relevant to achieving a competitive economy, identifying broader approaches to public spending while making specific recommendations in certain areas.

Increased fiscal accountability means that the risks associated with Scottish policymaking are higher. But there can also be broader public gains of economic growth. As KPMG note in their evidence to the Commission, for every pound of additional economic growth in the economy (GVA) some 38p is raised in additional tax, with over half of all Scottish tax revenues soon flowing directly to Scotland.

This underlines the importance of robust scrutiny of policy choices by the Scottish Government - something that we feel has not received enough attention to date. We address this in more detail in Chapter 7.

The powers of the Scottish Government and Parliament cannot be addressed in isolation. Scotland's local government also has a role to play in contributing to economic development. While the main function of local government is public service delivery (e.g. education, social care), the decisions it makes in a wide range of other areas impact on local business activity and employment (e.g. planning and regulation).

Central grant funding is the means whereby services are delivered by local government on behalf of central government to implement its policy choices. However, the link between local government policy decisions and their impact on local areas, on the one hand, and the autonomous tax revenue of local government has recently eroded further. COSLA, in their evidence to the Commission, illustrates the level of local fiscal autonomy across Europe:

Figure 6.1: Local Tax as % of Total Revenue for Local Governments

Source: COSLA submission to Commission, June 2015

It has to be pointed, however, out that one of the reasons for this imbalance is the considerable spending power of UK and Scottish local authorities, since they are responsible for a broader range of service delivery on behalf of central government than some of their European equivalents.

6.2 Scotland's Economic Performance

The Commission primarily drew on National Statistics publications, State of the Economy reports, Government Expenditure & Revenue Scotland (GERS) and a multitude of papers produced by the Scottish Parliament's Information Centre (SPICe) to establish an overview of the Scottish economy. These facts and figures provide the background to our recommendations.

6.2.1 Gross Domestic Product

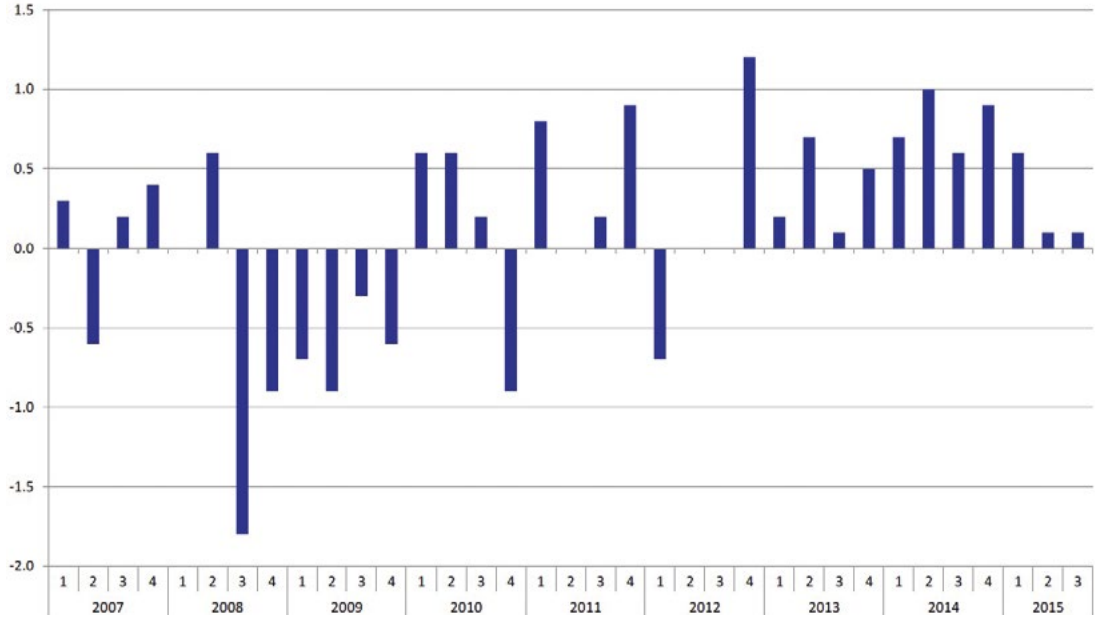
The latest National Statistics publication for Scotland[2] includes an overview assesment of the Scottish economy that the Commission was able to draw on. The publication finds that over the decade 1998-2008 the Scottish economy grew in real (volume) terms at an average rate of around 2.3% per year. This period of strong growth ended in the second half of 2008 when the global financial crisis and subsequent recession affected the Scottish, UK and international economies.

Growth resumed in 2010, but at a slower rate than before 2008 and with several quarters during 2010-2012 of low or negative growth. There has been steadier growth since the start of 2013, and Scottish GDP is estimated to have returned to its pre-recession level, in volume terms, during the first quarter of 2014. Latest figures show that the Scottish economy enjoyed 12 quarters of consecutive GDP growth.

However, the last two quarters have seen a significant slowing down in economic growth levels in Scotland, with growth much slower than the UK as a whole. Both Q2 2015 an Q3 2015 recorded growth at 0.1%, compared to a 0.7% and 0.4% growth UK-wide respectively. As discussed below, one of the primary reasons for this is a slowing down in the rate of expansion in public infrastructure investment. The latest figures also reflect the impact of a sustained fall in the oil price, which has now become the primary economic challenge for the North East of Scotland, with knock-on effects on Scotland's economy as a whole.

2 Scottish Government, Quarterly National Accounts Scotland, November 2015

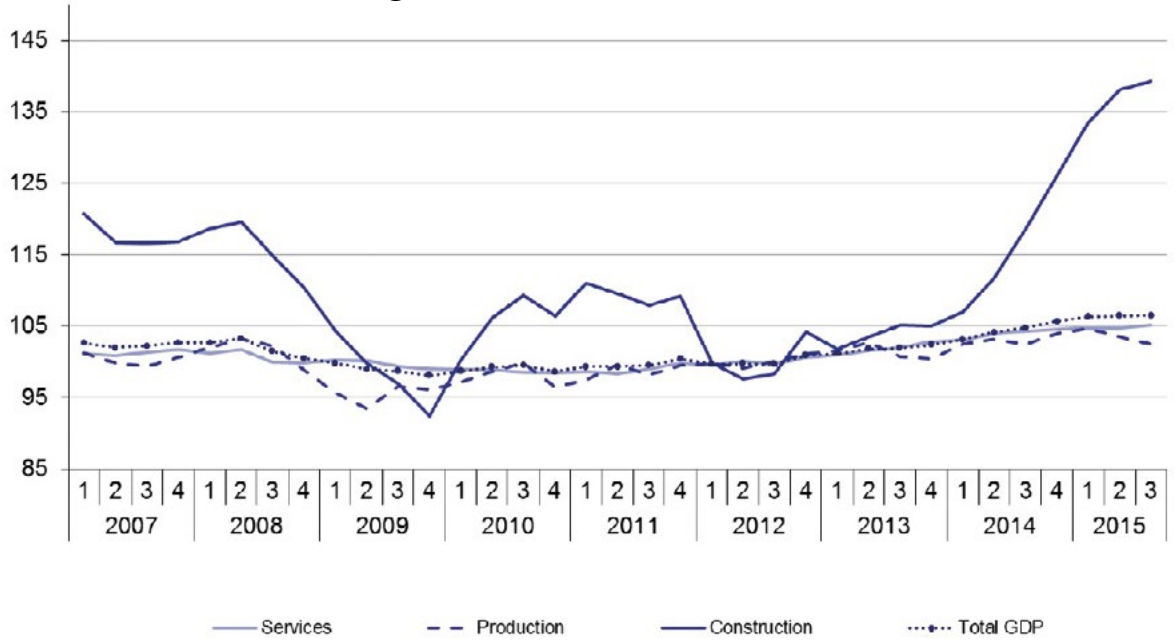
Figure 6.2 – GDP Quarterly Growth Rates 2007 – 2015 Q3



Source: Gross Domestic Product: A National Statistics Publication, January 2016

An analysis of GDP growth by sector underlines the challenges faced by the Scottish economy. The graph below makes it clear that the strong growth experienced since 2013 is driven mainly by construction (which grew by 18.5% over the year), with services and production lagging behind (growing by 0.8% and 0.5% respectively).

Figure 6.3 – Construction Driving GDP Growth



Output – Chained Volume Measure, seasonally adjusted, 2012 = 100
Source: Gross Domestic Product: A National Statistics Publication, January 2016

Moreover, the levels of growth seen in the construction sector are unusually high. The Chief Economist of the Scottish Government[3] provides a breakdown of this growth and concludes that much of it was driven by large scale public sector investment in new work, which he opines is unlikely to continue indefinitely. In his latest December 2015 report he expects public sector investment to decline and the balance of investment to return to the private sector.

This is echoed by the latest EY Scottish ITEM Club economic report, which shows that while the construction sector only represents around 6% of the Scottish economy, it accounts for 40% of GDP growth over the last two years. This has led to the conclusion that while "construction is Scotland's stand-out sector, the pace of growth may not be sustainable."

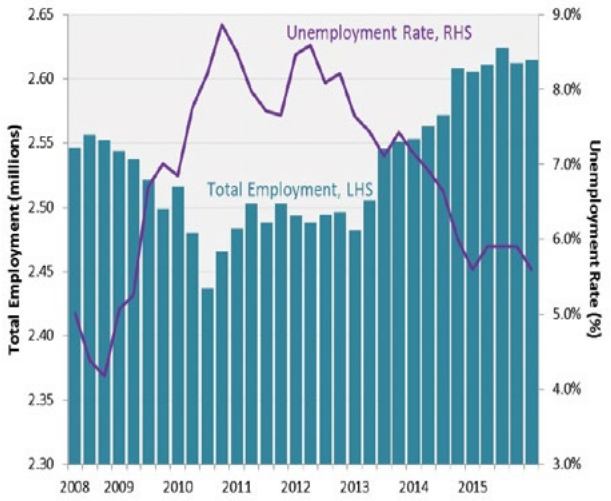
3 Dr Gary Gillespie, State of the Economy, August 2015

6.2.2 Labour Market

The overall picture of the Scottish labour market over the last 5 years is a positive one, with employment levels reaching their pre-recession

levels, unemployment falling, the number and share of full-time workers rising, and improved youth participation in the labour market.

Figure 6.4 – Scottish Labour Market 2008 - 2015



Source: Scottish Government, State of the Economy, December 2015

The last few months saw slight increases in unemployment and dips in employment (although it still remains above UK levels), which could cause concern should they become a trend.

The latest Annual Survey of Hours and Earnings shows that median gross full-time annual pay in Scotland increased by 2.5% in cash terms over the year to April 2015, reaching £27,710. In comparison, the UK as a whole saw an increase of 1.6% to £27,645. For the first time since 1997, when the survey started, median gross full-time pay in Scotland is higher than the UK average. The survey also shows that part-time weekly median pay in Scotland is higher than the UK average and that gross median weekly pay increased across all age groups in the year to April 2015.

Looking at the breakdown of the Scottish labour market by occupational category, we can see that it is broadly similar to the UK in its patterns. The biggest difference is in major groups 1-3 (higher paid professional jobs), where Scotland's proportion is lower at 41.8%, as compared with the UK as a whole at 44.1%.

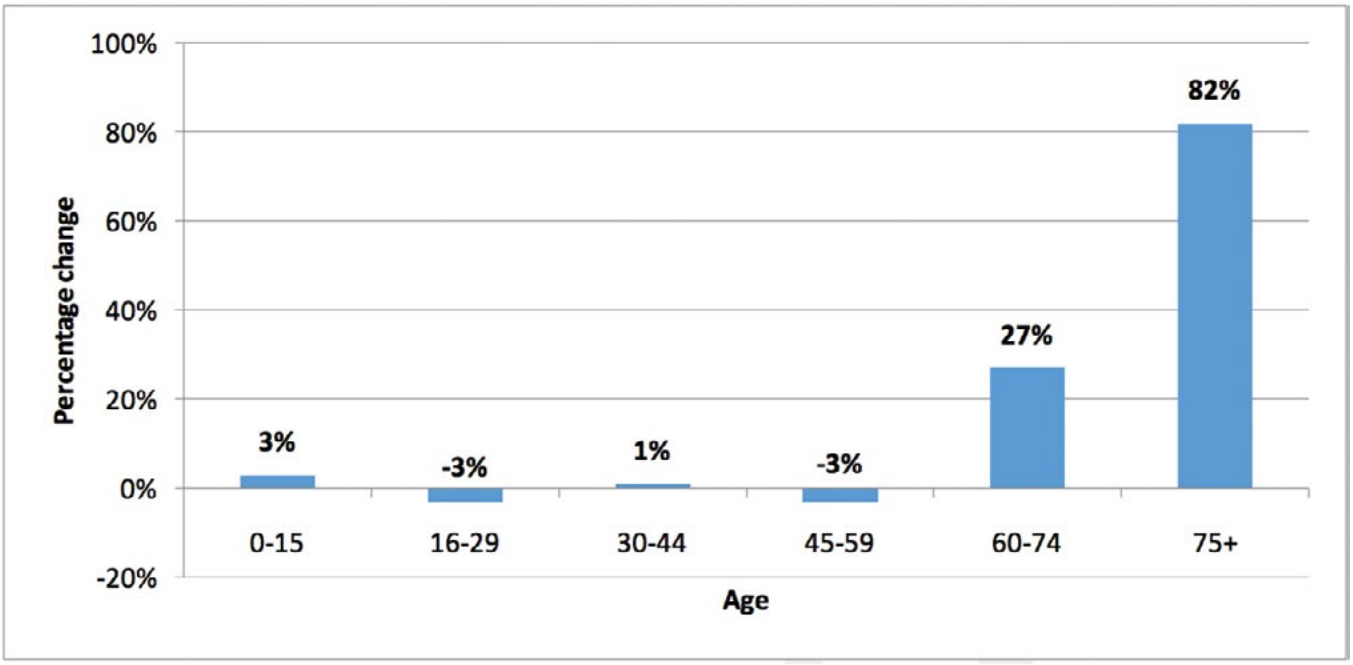
Figure 6.5 – Scottish and UK Employment by Occupation

	Scotland (Level)	Scotland (%)	UK (Level)	UK (%)
Soc 2010 Major Group 1-3	1,068,200	41.8	13,502,800	44.1
1 Managers, Directors And Senior Officials	226,000	8.8	3,150,200	10.2
2 Professional Occupations	509,200	19.8	6,055,700	19.7
3 Associate Professional & Technical	333,100	13	4,296,900	14
Soc 2010 Major Group 4-5	567,600	22.2	6,605,500	21.6
4 Administrative & Secretarial	278,100	10.8	3,291,500	10.7
5 Skilled Trades Occupations	289,500	11.3	3,314,000	10.8
Soc 2010 Major Group 6-7	480,300	18.8	5,227,600	17.1
6 Caring, Leisure And Other Service Occupations	254,600	9.9	2,845,800	9.2
7 Sales And Customer Service Occs	225,800	8.8	2,381,800	7.7
Soc 2010 Major Group 8-9	442,000	17.3	5,278,400	17.2
8 Process Plant & Machine Operatives	155,200	6	1,945,300	6.3
9 Elementary Occupations	286,800	11.2	3,333,000	10.8

Source: Nomisweb; ONS Annual Population Survey

One of the main challenges for policymakers in the future will be demographic change and the changing ratio between working-age and retired populations. In 2012, the Scottish Parliament's Finance Committee conducted an inquiry into this issue, with the submission from the National Records of Scotland providing evidence on population projections. The submission shows that although Scotland's working age population is set to increase by 7% between 2010 and 2035 (and those under 16 by 3%) those of pensionable age will increase by 26% over the same period - and these projections already take into account planned changes in the retirement age.

Figure 6.6 – Projected Change in Scotland's Population 2010-2035



Source: National Records of Scotland

As a result of these demographic changes, the dependency ratio (ratio of people aged under 16 and over pensionable age to those of working age) is projected to rise from 60 per 100 in 2010 to 64 per 100 in 2035. This has a clear impact on the sustainability of public services, especially in health and social care. These challenges are of course not unique to Scotland. However, the pace of this change is a bigger problem in Scotland than in most of Europe. More specifically, the proportion of Scotland's population that is of pensionable age is projected to increase by 2.9 percentage points between 2010 and 2035, compared with a 1.7 percentage point rise for the UK as a whole.

Many factors influence these projections, chiefly fertility, mortality and migration. The extent to which the Scottish Government can use policy levers to influence these factors will vary, since attracting talent into Scotland to improve the dependency ratio will partly depend on policy choices that are reserved to the UK Government.

But the benefits of inward migration to Scotland should be recognised. The NRS submission we refer to above, for example, estimates that a "high migration" scenario would result in population growth across all age categories, with the 1% growth in the 30-44 age range increased to ca. 10% and the dependency ratio falling by 2%.

6.2.3 Productivity

Although it is difficult to define consistently, productivity is a measure of how well an economy uses resources to produce output and is seen as a fundamental determinant of international competitiveness and living standards.[4]

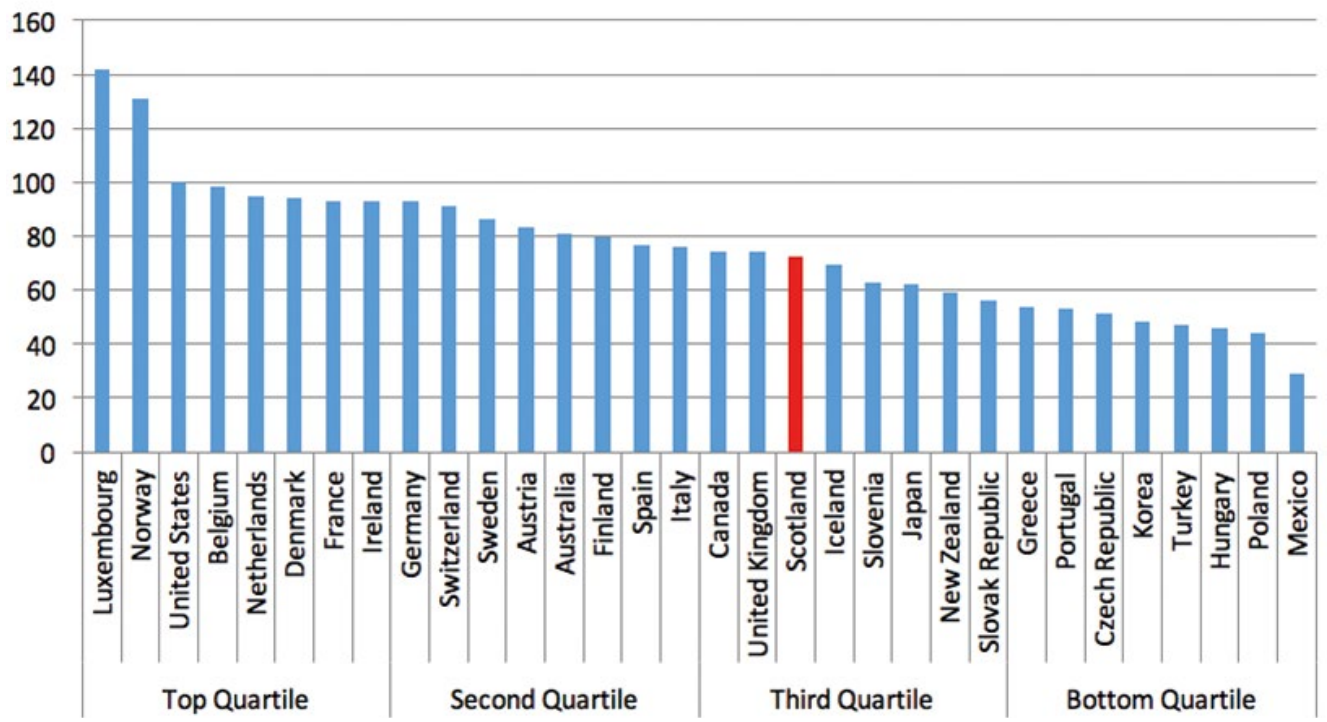
Both the Scottish and UK governments have in recent years increased their focus on productivity by undertaking more thorough research into the drivers of productivity growth and, as a result, introducing several productivity strategies.

4 SPICe, Productivity, August 2014

While employment has been rising steadily over the last 5 years, productivity has remained relatively flat across Scotland and the UK. More recent months have seen pay growth (coupled with near-zero inflation) while employment growth has slowed slightly, suggesting that pay rises are becoming a higher priority to the private sector than jobs growth. It remains to be seen whether this is accompanied by a rise in productivity too.

Scotland's labour productivity is lagging slightly behind the UK and both countries sit in the third quartile of the 32 top performing OECD countries.

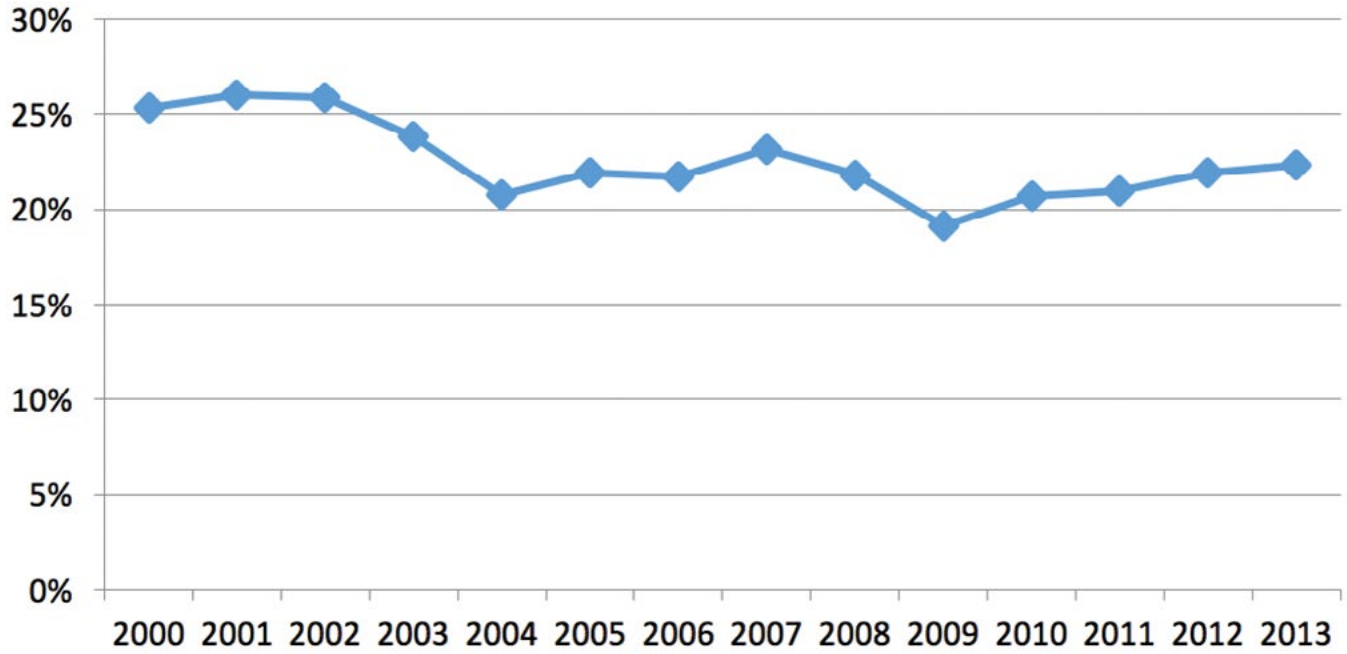
Figure 6.7 – Scotland's Productivity



2013 GDP per hour worked (USA=100)
Source: Scottish Government's ScotPerforms Website

The Scottish Government's Purpose Target framework includes a productivity target: "To rank in the top quartile for productivity against our key trading partners in the OECD by 2017". The last few years have not seen the necessary progress towards this target, since the gap between Scottish productivity and the top quartile has widened, as shown in the table below. In 2009 the gap between Scotland and Germany (the lowest ranked country in the top quartile) stood at 19.1%: this gap grew to 22.3% by 2013 (with Germany having been replaced by Ireland and France).

Figure 6.8 – Scotland's Productivity Gap



Percentage gap between Scottish Productivity levels and the lowest ranked country in the top quartile
Source: Scottish Government's ScotPerforms Website

While there is consensus on the importance of productivity to the economy and living standards, opinions differ on what drives productivity growth and what the government's role – if any is in this process. The Scottish Government's Economic Strategy from March 2015 identifies several productivity drivers and sets out its perceived role of government in achieving productivity growth. Amongst others, it identifies[5] :

- Helping firms to compete in international markets
- Investing in Scotland's transport and digital infrastructure
- Supporting innovation and commercialisation
- Ensuring education is responsive and aligned to demand
- Effectively utilising Scotland's public resources
- Providing effective and accessible enterprise support.

Elsewhere, Professors Peter McGregor and Kim Swales of Strathclyde University have also highlighted key drivers of productivity[6] :

- Technical change: mainly through corporate investment in new technologies and adoption of new processes
- Investment in human capital: for example formal educational qualifications as well as effective on-the-job training
- Public investment in 'appropriate infrastructure': transport, communications and energy transmission and distribution networks.

The IMF[7] studied productivity drivers in great detail and concluded the following have been found to increase productivity growth:

- Higher quality and quantity of infrastructure and human capital
- Trade openness
- Efficient and well-developed financial systems
- Appropriate tax and expenditure policies
- Sound economic institutions that promote competition, facilitate entry and exit, and encourage entrepreneurship and innovation.

5 http://www.gov.scot/About/Performance/scotPerforms/purpose/productivity
6 SPICe, Scotland's economy: recent developments, January 2014
7 IMF, Anchoring Growth: The Importance of Productivity-Enhancing Reforms in Emerging Market and Developing Economies, December 2013

6.2.4 Business Growth and Structure

The Scottish Government's Businesses in Scotland 2015 publication gives us a summary of the business landscape in Scotland and the changes experienced over the last decade. As at March 2015, the number of private sector enterprises operating in Scotland was estimated to be 361,345. This is the highest figure since the time series began (in 2000) and represents an increase of 7.8% (26,090 enterprises) year on year.

The increase over the latest year was driven by a rise in the number of unregistered businesses by 22,280 (+13.2%). The number of VAT/PAYE registered businesses has increased also - up by 3,810 (+2.3%) from 166,525 in 2014 to 170,335 in 2015 – taking the number of registered businesses in Scotland to its highest level in the series.[8]

The following table shows a breakdown of enterprises by the number of employees. It shows that the increase in enterprises is largely driven by an increase in the number of self-employed. 87% (52,280) of the 60,420 increase since 2010, was attributed to 0 band enterprises.

These figures suggest to us that a major challenge seems to be in enterprises transitioning from medium to large (those in the 100-249 employee band), as these account for a very small percentage of all enterprises with employees – 1.6%.

Breaking down these statistics by turnover and employment shows the importance medium and large businesses to the Scottish economy. The latest figures show that while the number of large businesses (250+) has remained relatively static over the last 15 years - with no growth between 2014 and 2015 - these businesses alone employ 44% of all Scottish employees (934,900) and account for 60% of all Scottish turnover (£161bn). Adding in medium-sized business employing between 50 and 250 people, we see that medium and large businesses alone employ 57% of the Scottish workforce and account for 74% of all Scottish turnover.

8 Scottish Government, Businesses in Scotland 2015, March 2015

Figure 6.9 – Number of Enterprises in Scotland by Employee Size Band

Employee size band (total UK employees)	Number of enterprises in Scotland					
	2010r	2011r	2012r	2013r	2014r	2015
0	201,765	214,350	238,670	241,395	229,865	254,045
1 - 4	60,780	59,840	63,390	60,750	63,420	64,205
5 - 9	17,885	17,515	18,465	18,610	20,040	20,530
10 - 19	9,775	9,605	9,970	10,480	10,890	11,345
20 - 49	4,815	4,650	4,570	4,965	4,965	5,055
50 - 99	2,050	2,005	2,015	2,080	2,145	2,200
100 - 199	1,305	1,325	1,300	1,275	1,290	1,330
200 - 249	295	305	320	350	345	340
250 - 499	760	750	770	795	795	785
500+	1,500	1,485	1,480	1,475	1,500	1,515
Total	**300,925**	**311,820**	**340,945**	**342,180**	**335,255**	**361,345**
0-49 Employees	295,015	305,960	335,060	336,205	329,180	355,180
50-249 Employees	3,655	3,630	3,635	3,705	3,780	3,870
250+ Employees	2,260	2,230	2,250	2,270	2,295	2,295
1+ Employees	99,165	97,475	102,280	100,785	105,390	107,300

Source: Businesses in Scotland 2015

It is important to point out that only around a quarter of these businesses are indigenous enterprises. BIS Business Population Estimates suggest that the number of large businesses headquartered in Scotland (as opposed to operating in Scotland) has remained the same over the whole available time-series (since 2010) - standing at 500 enterprises. This suggests that in order to harness the greatest economic benefit, policy should focus on not only attracting large employers into Scotland, but also on supporting the growth of medium-sized companies into large businesses.

The breakdown of enterprise and employee statistics by business sector also provides a valuable insight into the Scottish economy. For example, it shows that while the retail sector only accounts for 5.6% of all enterprises (7th out of 18), it accounts for 12.4% of all employees in Scotland – the largest percentage by far.

Figure 6.10 – Scotland's Enterprises by Industry

Industry	Enterprises	% of Total	Employees	% of Total
Agriculture, Forestry and Fishing	21,480	5.9%	60,550	2.9%
Mining and quarrying, utilities	3,390	0.9%	69,180	3.3%
Manufacturing	17,485	4.8%	194,520	9.2%
Construction	48,135	13.3%	152,950	7.3%
Motor trade incl. vehicle repairs	8,905	2.5%	46,990	2.2%
Wholesale trade	8,245	2.3%	72,750	3.5%
Retail trade incl. fuel sales	20,395	5.6%	260,660	12.4%
Transportation and storage	19,455	5.4%	102,370	4.9%
Accommodation and food service activities	19,060	5.3%	189,190	9.0%
Information and communication	15,200	4.2%	67,140	3.2%
Financial and insurance activities	3,665	1.0%	91,800	4.4%
Real estate activities	6,575	1.8%	33,420	1.6%
Professional, scientific and technical activities	53,450	14.8%	169,060	8.0%
Administrative and support service activities	26,305	7.3%	186,200	8.8%
Education	18,480	5.1%	89,060	4.2%
Human health and social work activities	26,870	7.4%	186,080	8.8%
Arts, entertainment and recreation	17,300	4.8%	71,670	3.4%
Other service activities	26,945	7.5%	64,110	3.0%
Total	**361,345**	**100.0%**	**2,107,690**	**100.0%**

Source: Businesses in Scotland 2015

6.2.5 Trade

Scottish international exports amounted to almost £28 billion (excluding oil and gas) in 2013, which represents a 7% increase year-on-year and a 20% increase since 2010. Much of the export activity depends on global market conditions and, domestically, on exchange rates, but the Scottish export picture is overall a positive one.

Figure 6.11 – Total International Exports by Industry Sector

	£ million					
	2010	2011	2012	2013	2012-2013 change	2012-2013 % change
Primary	1,530	1,530	1,315	1,365	50	3.7
Large	830	850	725	850	125	17.5
Medium	500	415	415	405	-5	-1.8
Small	195	265	175	105	-70	-39.9
Production & Construction	13,610	15,555	15,940	17,185	1,245	7.8
Large	9,300	10,645	10,405	10,985	580	5.6
Medium	3,410	3,860	4,305	5,275	975	22.6
Small	900	1,050	1,230	920	-305	-24.9
Services	7,955	8,535	8,650	9,235	590	6.8
Large	3,115	3,615	3,350	3,525	175	5.2
Medium	1,705	1,835	2,020	2,195	175	8.6
Small	3,135	3,085	3,275	3,515	240	7.3
Total Exports	**23,165**	**25,715**	**26,015**	**27,875**	**1,860**	**7.2**
Total Large	13,245	15,110	14,485	15,365	880	6.1
Total Medium	5,620	6,110	6,740	7,880	1,140	16.9
Total Small	4,235	4,400	4,680	4,545	-135	-2.9

Source: Scotland's Global Connections Survey 2013

Nevertheless, the breakdown opposite, exposes the difficulties faced by the smallest (<50 employees) Scottish companies in boosting exports. The latest figures show a drop of 2.9% in exports by small companies year-on-year, compared to a growth of 6.1% for large companies and 16.9% for medium companies. Since 2010, exports by the largest companies increased by 16%, medium companies by 40%, but small companies only by 7.3%.

In terms of breakdowns by sector, the two largest exporting industries in 2013, as in previous years, were manufacture of food & beverages (£5 billion, 18% of all exports) and manufacture of coke, refined petroleum and chemical products (£3.5 billion, 12.6% of all exports). These 2 sectors are followed by legal, accounting, management, architecture, engineering, technical testing and analysis (£1.9 billion), manufacture of machinery and equipment (£1.7 billion) and manufacture of computer, electronic & optical products (£1.6 billion).

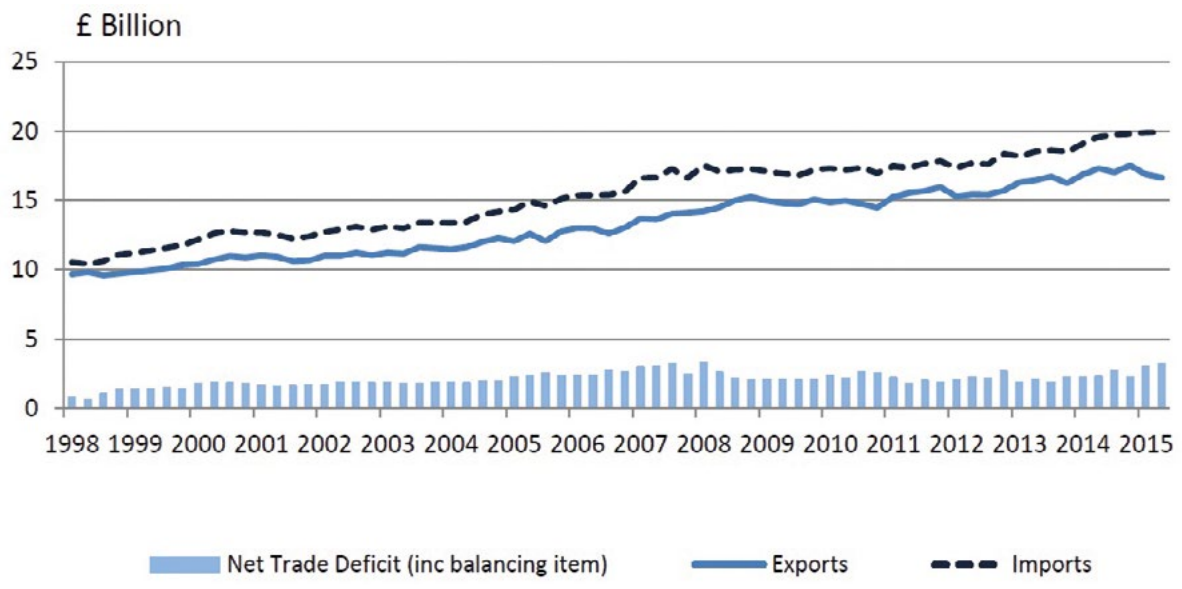
The top five international export markets (USA, Netherlands, Germany, France, and Denmark) accounted for £11.2 billion of international exports (40% of all international exports) from Scotland.[9]

There are difficulties in ascertaining the final destination of sales within the UK due to the collation of financial statistics at below UK level. However, Scotland's Global Connections Survey does provide estimates of Scottish exports to the rest of the UK, which in 2013 reached £46.2 billion – 62% of all exports (international and rUK combined).

Further difficulties arise in determining import levels into Scotland. The lack of import data for Scotland due to the absence of regional reporting requirements makes producing estimates difficult. Nonetheless, the Scottish Government's Quarterly National Accounts estimate that Scotland has run a substantial onshore trade deficit in every year since devolution. The 2014 onshore trade deficit was estimated at £9.2 billion.

9 Scotland's Global Connections Survey 2013

Figure 6.12 – Scottish Trade at Current Market Prices



Source: Quarterly National Accounts

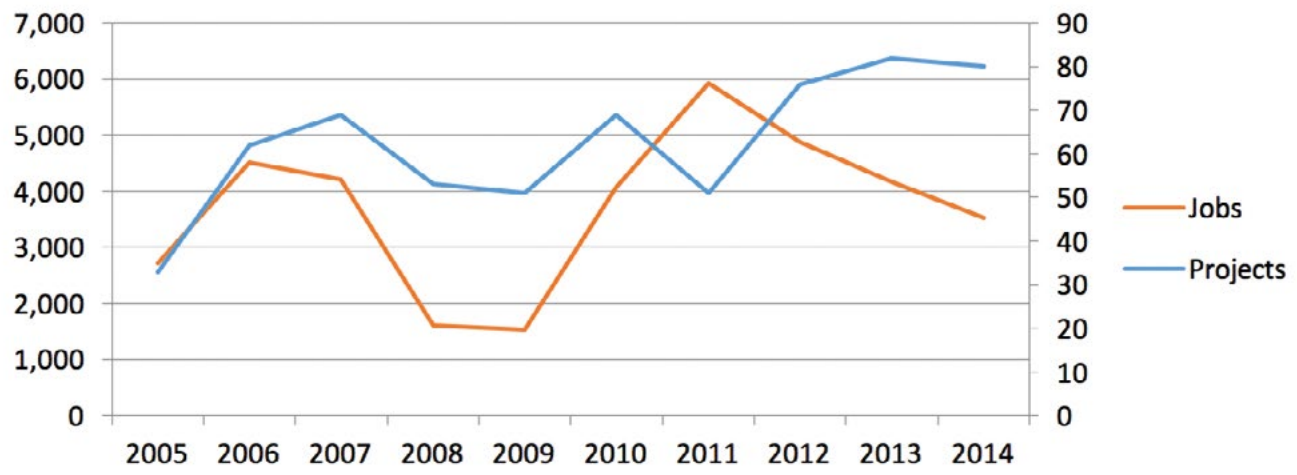
6.2.6 Foreign Direct Investment (FDI)

EY's 2015 UK attractiveness survey in Scotland has shown that Scotland attracted its third highest number of FDI investments on record in 2014, second only to London in the UK, albeit slightly down from the sixteen-year high recorded in 2013.

This, of course, only includes announced projects recorded through a survey and is therefore not a completely accurate reflection of investment in Scotland. Nonetheless, the data is useful in allowing comparisons to be drawn between UK regions on the same measure.

The small decline in 2014 was accompanied by a steeper decline in the number of jobs created through FDI, but EY concludes that this reflects the shift in the type of investment towards an increase in scientific investment – potentially high-value, but generating fewer jobs.

Figure 6.13 – Foreign Direct Investment in Scotland



Source: EY's Global Investment Monitor 2015

Two main challenges are identified by EY – a relatively low proportion of FDI from new investors (as opposed to expansions) and a low recognition of Scotland as an investment destination in Asia. Last year, the UK as a whole won 604 new investor projects out of a total of 887 – a proportion of 68% – but Scotland won only 30 brand new projects out of a total of 80, a proportion 37.5%, with the remaining 50 being expansions by existing investors. Furthermore, while 2014 was Scotland's most successful year ever in attracting investments from the US, China – the fifth-biggest investor into the UK – was not even among Scotland's top 10 sources.

While FDI undoubtedly plays an important role in specific sectors, its overall role in Scotland's labour market growth is relatively small, accounting for only 7.4% of Scotland's 48,000 new jobs in 2014. In terms of the existing labour market, the role of foreign-owned (and therefore more mobile) businesses is a significant one. The latest Scottish Annual Business Statistics show that while in 2013 only 4.6% of business sites in the Scottish non-financial business economy were foreign-owned (owned outside the UK), these businesses contributed 34.6% of Scotland's non-financial business economy GVA and employed 284,000 (16.4%) people.

6.3 Summary and Identified Objectives

In summary, Scotland's economy is characterised by:

- A labour market dependent on a small number of large companies and a large number of very small businesses
- A population aging faster than the rest of the UK and the European average
- A mutually dependent trading relationship with the rest of the UK
- A narrow export market and the need for higher levels of export opportunities
- A reliance on oil & gas and financial services in Scottish city regions
- A dependence on foreign investment and especially the retention of existing foreign-owned companies
- A GDP growth level masked by an unsustainable rate of expansion in public infrastructure investment

Accordingly, a competitive tax regime at UK and Scottish level is essential to address these issues and to provide incentives for businesses to take advantage of global market opportunities. This does require a level of cooperation and policy coherence between the Scottish and UK governments, but the opportunities of further devolution place some of the onus on Holyrood too. In identifying the broad areas on which we think policy should focus, we were guided by our given remit:

"How can existing and post-Smith powers best be used to promote Scotland's economy and competitiveness, while ensuring strong and sustainable public services and a regime which is fair to the taxpayer?"

Within this remit, having considered the state of the Scottish economy and having identified the key principles to follow, it is our view that the range of powers at the disposal of the Scottish Government should be used to create an economic environment in which:

- Scottish businesses grow in size and number
- Skills align with demand and further talent is attracted to - and retained in - Scotland
- Transparency and accountability improve across all tiers of government

The recommendations we make in this report are all aimed at making progress in these areas and we make it clear in the individual sub-chapters, as well as a more explicitly in the conclusion, as to why we think this is the case.

7. TAXATION POWERS

The devolution of further tax powers to the Scottish Parliament in the Scotland Act 2012 - following Calman Commission recommendations - and the soon-to-be Scotland Act 2016 - following Smith Commission recommendations – gives MSPs and councillors in Scotland control over personal and business taxes amounting to £15 billion (excluding VAT).

The table below offers a breakdown of these new tax powers by revenue generated in the fiscal year 2013/14 (taken from GERS 2015).

Figure 7.1 – New Tax Powers by Revenue Generated

	Scotland Act 2012 (£m)	Scotland Act 2016 (£m)
Income Tax	4,258	10,911
Stamp Duties (LBTT)	385	385
Air Passenger Duty	0	251
Landfill Tax	105	105
Aggregates Levy	0	50
Non-domestic Rates[1]	1,927	1,927
Council Tax	1,941	1,941
Assigned VAT	0	5,030
Total devolved and assigned revenues	**8,617**	**20,600**

Excludes NDR that local authorities pay themselves.
Source: Government Expenditure and Revenue Scotland, March 2015

We make recommendations across this suite of taxes, categorised across two axes - national/local and personal/business. But we begin with a series of recommendations that we believe apply to the tax system as a whole. These are outlined in the section titled Overarching Approach.

Most changes to taxation will have potentially significant impacts on revenue. These will be both "static" revenue changes (as a direct result of the tax change) and "dynamic" revenue changes due to behavioural impacts. We have considered these in light of the evidence we received as well as available comparative research. In addition to the usual range of factors that affects tax revenues (and, consequently, public spending), negotiations on the fiscal framework accompanying the Scotland Act 2016 have not yet concluded. Our tax recommendations are necessarily broad, bearing in mind that specific choices will have to be made by policymakers following final agreement.

In any case, our Call for Evidence made it clear that we did not believe it was – or should be – part of our remit to propose specific rates or thresholds of individual taxes. Setting different thresholds for bands of council tax, for example, will have a major impact on revenue, without necessarily changing the competitiveness of the economy. These decisions are of a political nature that individual parties will have to make ahead of the production of their manifesto. Our recommendations therefore relate to broad tax design with a view to guiding political parties in a specific direction.

Our remit did not include an analysis of local government structures. Nonetheless, our discussions inevitably included a consideration not only of tax design, but also of where tax powers should lie - especially in light of the evidence we received on local government autonomy.

7.1 Overarching Approach

There are obvious difficulties with attempting to analyse the impact of tax changes on the Scottish economy. Firstly, the nature of the constitutional settlement in the UK makes comparative analysis with other countries especially difficult. Whilst federal countries can be used to compare levels of fiscal accountability, they cannot serve as direct parallels in evaluating tax changes since their mix of powers differs significantly. Secondly, most comparative research still looks at the United Kingdom as a unitary tax system and does not account for recent fiscal devolution. Thirdly, the focus of much of the research work done to analyse the relationship between tax policy and growth is on corporate taxation, over which Scotland will not have control (with the exception of business rates).

One of the primary reasons for the setting up of our Commission was to enable an analysis of the basket of Scottish tax powers as a whole, in contrast with the irregular reviews and adjustments to existing powers, especially council tax and non-domestic rates. During this process, we have been conscious of keeping in mind the overall tax burden on individuals and businesses, arising from direct and indirect taxes levied by all tiers of government.

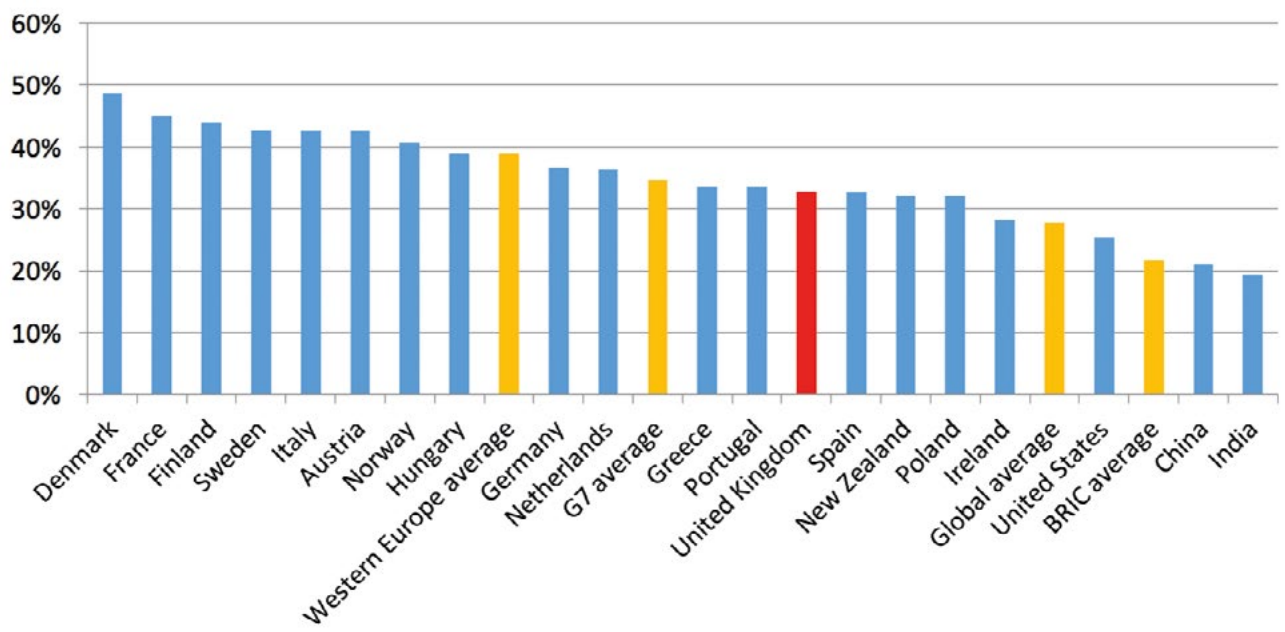
In addition, we had to take account of Scotland's position on the geographical periphery of Europe. While multiple factors influence competitiveness, our greater distance from trading partners, coupled with a relatively poor transport infrastructure, does have an impact on our imports and exports, especially compared with the southern part of Great Britain, which has a more advantageous position for trade with continental Europe.

Most recently, accountancy firm UHY Hacker Young Group compiled international tax and GDP data[10] to rank countries by their overall tax revenue as a percentage of their GDP. This is relatively crude basis of comparison that does not account for labour market differences, productivity or any quality of life measures, but it can be used to compare the tax burden in broadly similar regions.

The table below shows that while the overall tax burden in the UK is higher than the BRIC or the Global average, it is lower than the Western European average or even the G7 average.

10 http://www.uhy-uk.com/news-events/news/uk-economy-saddled-with-tax-burden-a-fifth-higher-than-the-global-average/

Figure 7.2 – Tax Revenue as % of GDP



Source: UHY Hacker Young Group Analysis, April 2015

This analysis takes no account either of different kinds of taxation (e.g. corporate, personal, indirect etc.) - indeed we show below that the UK's personal top tax levels are significantly above G7 averages - nor does it provide any insight into the dynamic relationship between tax levels and economic growth.

Literature on the impact of tax rises on economic growth is extensive and varied. We have drawn on excellent literature reviews contained in two publications - a Policy Exchange paper[11] which summarised 17 different empirical and theoretical studies and a Tax Foundation paper[12] which summarised 26 different pieces of research.

Both papers find that academic literature is consistent. Despite significant variance in methodology, data or scope, the vast majority of researchers find that tax rises have a negative effect on economic growth. Across these studies, tax rises can either mean (i) an increase in the overall tax to GDP (sometimes income) ratio or (ii) changes to specific tax rates, with the effects measured in GDP growth or changes to per capita output.

McBride finds that out of 26 studies since 1983, all but three (and all in the last 15 years) found these effects. Lilico and Sameen find that only one out of 17 studies concluded there is no discernible relation between tax and economic growth. The negative impacts analysed range from relatively small effects on GDP growth to more significant downturns in investment levels, output per worker and growth rates - up to 2% annually.

One of the most comprehensive studies by Romer and Romer[13] looked at all legislated federal tax changes in the USA from 1945 to 2007, but also took the unique step of isolating tax changes whose effects were unlikely to be contaminated by other developments affecting output - so-called exogenous tax changes. Their results suggest that an exogenous tax increase of one percent of GDP lowers real GDP by 2-3 percent. In addition, they find that investment falls sharply in response to exogenous tax increases.

Similarly, in a European Central Bank working paper, Afonso and Furceri[14] analyse tax changes across 28 OECD and EU countries over seven five-year periods between 1970 and 2004 and find that a 1 percentage point increase in the tax revenue to GDP ratio lowers per capita GDP growth by 0.12-0.13 percent.

While these findings are important, it is the impact of specific types of taxes that were more relevant for the purposes of this Commission. Not all studies differentiate between different taxes (they focus on the overall tax burden in a country), but out of those that distinguish between types of taxes, corporate income taxes are found to be most harmful, followed by personal income taxes, consumption taxes and property taxes[15] . With corporation tax remaining a reserved tax as far as Scotland is concerned, the full devolution of income tax and the existing non-domestic rates present both the greatest opportunities and dangers to the Scottish economy.

Moreover, fiscal decentralisation, poses opportunities and challenges in and of itself. The possibility of differing rates of tax within the United Kingdom and the consequent impact on the Scottish economy needs to be studied from the perspective of intra-UK tax competition and mobility. We do this in the sections on individual taxes, but it is clear that the policy focus should be on income tax and non-domestic rates - both as by far the largest of Scottish taxes on individuals and businesses respectively and as the ones with the biggest impact on the economy.

In what follows, individual sub-chapters contain more evidence relevant to specific tax types as well as individual recommendations. However, there are a number of recommendations that apply to the tax system as a whole.

Whilst applying our five key principles, and the twin concepts of competitiveness and fairness, we have identified the following overarching approaches to taxation in Scotland:

1. In designing new taxes and reforming existing ones, the focus should be on minimising complexity for taxpayers. Reliefs and exemptions should be kept simple.
2. A low target administration percentage should be set, monitored and reported on.

11 Lilico, A. and Sameen, H., Taxation, Growth and Employment, Policy Exchange, March 2010
12 McBride, W., What is the Evidence on Taxes and Growth?, Tax Foundation, December 2012
13 Romer, C. D. & Romer D. H., The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks, American Economic Review 100 (June 2010): 763–801
14 Afonso, A. & Furceri, D., Government Size Composition, Volatility and Economic Growth, ECB Working Paper, No 849 / January 2008
15 Ibid. pg. 2

3. Taxes on income should be progressive and be relatively smooth throughout the scale.
4. Taxes should be transparent, predictable and easy to understand for both business and personal taxpayers.
5. Scotland's overall tax burden should not be higher than that of our nearest competitors.
6. Scottish taxes should be designed to retain and attract the skilled people consistent with delivering our aspirations for a fair and competitive economy and society.

7.2 Personal Taxes

7.2.1 National Taxes

Income Tax

SCOTTISH RATE OF INCOME TAX

Following the recommendations of the Calman Commission, and the passing of the Scotland Act 2012, the Scottish Parliament will set its first Scottish Rate of Income Tax (SRIT) in the 2016/17 Budget. This power gives the Scottish Parliament control over 10p out of each income tax band (ca. £4.3bn in 2013/14), which can be changed up or down, but only "lockstepped" in tandem across all three bands.

The debate, which followed the introduction of the Draft Budget in December 2015, suggests a consensus amongst all political parties - since the full devolution of income tax is planned to commence in April 2017, the SRIT should initially be kept in parity with the rest of the UK to ensure a smooth transition. We believe this is the right approach and have therefore decided not to make any recommendations in relation to the Scotland Act 2012 SRIT power.

BACKGROUND

The soon-to-be Scotland Act 2016 devolves non-savings non-dividend (NSND) income tax to the Scottish Parliament almost in full. The personal allowance (starting threshold) remains reserved, as do any reliefs, but beyond that, the Scottish Parliament will be responsible for setting rates, bands and thresholds of income tax from April 2017.

In terms of yield, NSND income tax will be by far the biggest tax devolved to Scotland, raising £10,911 million in 2013/14 - more than double the amount of all other devolved taxes combined. This also means that changes in bands, rates or thresholds will significantly impact on Scottish revenues. For example, we estimate that the static revenue foregone would be circa £300 million if the basic rate were cut by 1p in Scotland and circa £440 million if the higher rate threshold was raised to £50,000 [16]. This does not take into account any dynamic revenue changes due to behavioural impacts.

In terms of taxpayers, in 2015/16, there were 2.52 million income taxpayers in Scotland. 82.9% of these are charged at the basic rate (2.09m), 14.8% at the higher rate (372,000) and 0.7% at the additional rate (17,000[17])[18] . In comparison with the UK as a whole, Scotland has a smaller proportion of middle income and highest income taxpayers, the equivalent UK percentages being 80.8%, 15.7% and 1.1%.[19]

Combining yield and taxpayer numbers, we get the following picture:

16 These figures are an adaptation of SPICe calculations.
17 In his October 2015 evidence to the Finance Committee, Professor David Bell estimates this number at 11,000
18 In addition, 41,000 taxpayers only paid the so-called "savers rate"
19 SPICe, Income Tax in Scotland, October 2015

Figure 7.3 – Scottish Income Tax Revenue by Band, 2012-13

£ millions					
	Taxpayers' marginal rate				
	Basic rate	Higher rate	Additional rate	Total	%
Basic rate	5,440	1,950	90	7,480	66.2%
Higher rate	-	2,390	603	2,990	26.5%
Additional rate	-	-	874	870	7.7%
Total tax	5,440	4,330	1,570	11,300	100.0%
%	48.1%	38.3%	13.9%	100.0%	

Source: SPICe, Income Tax in Scotland, October 2015

The data shows that basic rate taxpayers representing 82.9% of all taxpayers contribute 48.1% of tax, while higher rate taxpayers representing 14.8% contribute 38.3% of tax. The most striking observation from the table, however, is the fact that additional rate taxpayers representing 0.7% contribute 13.9% of all tax revenue in Scotland - over £1.5 billion. Consequently, changes to the number of additional rate taxpayers (increases or decreases) would have an exponentially higher impact on tax revenues. We analyse the evidence on taxpayer mobility in the next section.

We also looked at international examples of income tax design, through the prism of our five key principles. The OECD provides a good overview of different tax rate structures throughout its 34 members[20] . The UK's 3 bands are comparatively rare, with the majority of countries structuring income tax under 4 or more bands.

20 https://stats.oecd.org/Index.aspx?DataSetCode=TABLE_I7

Countries that are often compared to the UK as part of discussions on devolution all have 4 or more bands (Canada has 4, Australia has 4, USA has 7 and Germany has linear progression not bands). A higher number of bands makes income tax progressivity smoother, with less pronounced jumps in tax rates at set thresholds.

In addition, the top rate of tax in the United Kingdom (45%) is higher than the EU (37.9%), OECD (41.7%) and Global (31.4%) averages.[21] An even more appropriate measure is the Marginal Effective Tax Rate, which measures the proportion of a workers' output that is claimed by government after taking account of all taxes.[22]

21 https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/individual-income-tax-rates-table.html
22 Manning, A., The Top Rate of Income Tax, CEP, 2015

Figure 7.4 – Marginal Effective Tax Rates

	Highest rate	METR (top 1%)	METR (average)
UK	45.00%	60.40%	49.10%
United States	46.30%	51.40%	44.70%
France	54.50%	69.20%	67.20%
Germany	47.50%	55.90%	66.60%
Denmark	56.20%	65.00%	53.80%
Sweden	56.70%	73.60%	58.40%
Japan	50.80%	53.90%	39.20%

Manning, A., The Top Rate of Income Tax, CEP, 2015

Thus the METR rate in the UK for the top 1% is significantly higher than in the US or Germany, but lower than Scandinavian countries or France.

ISSUES TO CONSIDER

As mentioned above, any significant increase or decrease in the number of additional rate taxpayers would have a significant impact on Scotland's budget. It is therefore crucial to understand the evidence on taxpayer mobility within the United Kingdom. Similar problems arise when trying to compare international evidence on income tax alone as when comparing studies on growth and the tax burden. Studies that have been conducted on a regional/sub-regional basis have found it challenging to link specific behavioural responses to changes in marginal tax rates considered in isolation from wider economic changes.[23]

Nonetheless, we were able to draw on several pieces of work which included literature reviews of academic research in this area. Anouk Berthier from SPICe analysed several empirical studies[24] and concluded that physical migration is likely to be higher for the highest income taxpayers. Additional rate taxpayers, such as those who work in either rUK or Scotland and live in the other and those who have second homes in Scotland or rUK, may find ways to migrate across the fiscal border between Scotland and rUK.

23 SPICe, Income Tax in Scotland, October 2015
24 SPICe, The Scottish rate of income tax and additional rate taxpayers, February 2014

In response to the Scottish Parliament's Finance Committee scrutiny of the Scottish Rate of Income Tax, Professor Gavin McEwen submitted a literature review of studies on the impact of sub-national income tax rates on migration. McEwen focuses on the same three countries as Berthier since they can provide the most useful comparisons, albeit neither is directly comparable to Scotland - Switzerland, Canada and USA. He concludes that "experience in Switzerland, the US and Canada gives us good reason to expect that relative changes in rates of income tax between Scotland and the rest of the UK, provided the differences are expected to persist, will have an effect on the migration decisions of high-income individuals."

The same inquiry received evidence from Professor David Bell, who also conducted a literature review on the behavioural responses to changes in income tax rates. Bell firstly identifies the groups of taxpayers who are most likely to migrate in response to lower tax rates - young workers (whose migration costs can be recouped over time) and higher earners (whose migration costs matter less to them).

Bell analyses behavioural impacts in US states and Swiss cantons which can differ in top marginal tax rates by over 10% and have varying levels of progressivity too. He concludes that "the worldwide evidence on behavioural responses to tax changes tends to agree only on the belief that higher income tax rates will lead to behaviours that have a negative effect on tax revenues. These include reducing labour supply, tax avoidance and migration."

On migration specifically, he adds: "There is also evidence from Denmark that high earners respond to tax incentives by changing their migration behaviour. If it is the case that the costs of migration have fallen in recent years, then there is a strong case for moving cautiously when considering changes to the higher rates of income tax in Scotland."

Between them, the three papers we consulted reviewed dozens of empirical studies and all, albeit cautiously, concluded that there is a risk of behavioural responses by higher earners to changes in their marginal rates of tax. In addition to migrationary responses, there is a higher risk of various tax avoidance measures being taken too - shifting from payment by self-employed income to incorporation and payment by profit, or to dividends rather than a salary.

We also considered the recent increases in the personal allowance, since the Scottish income tax powers could theoretically be used to introduce a nil rate band. The increase from £6,475 in 2010/11 to £10,000 in 2015/16 had the effect of taking over 230,000 Scottish taxpayers out of income tax altogether, which represented a significant tax cut, but also a shrinking of the tax base by around 10%. This makes public finances more vulnerable to economic shocks and the slowing down of recovery after such shocks. The higher the personal allowance, the lower the public finance gains of increasing employment. Policymakers have to balance these risks against the gains from increased taxpayer earnings.

RECOMMENDATIONS

1. Given the very small number of additional rate taxpayers in Scotland, any significant increase in personal taxes could be counter-productive. The top rate of income tax should not be higher in Scotland than in our nearest competitors at any given time.
2. A new (circa 30%) income tax band should be introduced between 20% and 40% to make income tax progressivity smoother. The thresholds for the band should not be used to increase income tax on basic rate taxpayers.
3. Policymakers should be wary of increasing the personal allowance above rUK levels via the introduction of a nil rate band as this could have significant consequences on Scotland's budget due to a further narrowing of the tax base.

Land and Buildings Transaction Tax (Residential)

We have treated the Land and Buildings Transaction Tax as two separate tax powers - Residential LBTT and Commercial LBTT. Recent history shows that stamp duty rates on residential property transactions were used primarily as a revenue raising tool. The rates inevitably affect the property market, as we discuss below, but they are not used with that aim. Commercial LBTT, on the other hand, can (and should) be used to incentivise or indeed disincentivise business development.

BACKGROUND

Property transaction taxes have seen significant changes over the last year. The devolution of Stamp Duty Land Tax in the Scotland Act 2012 meant that

the Scottish Parliament set its own rates of the tax - renamed LBTT - from April 2015. In addition, the design of the tax itself changed fundamentally on both sides of the border. The old slab structure of the tax (where tax was collected on the whole value of the property above a threshold) was replaced by a more progressive approach (tax payable only on the slice of the property value above a threshold) - something universally welcome.

The rates and thresholds, however, differ significantly north and south of the border. We discuss evidence on the implications of this below, but it is clear that the Scottish reforms place a greater burden on the top of the property market. Recently, both the UK and Scottish governments announced an additional 3% levy on transactions for those buying second homes and buy-to-let landlords.

Figure 7.5 – SDLT and LBTT Rates

rUK 2015/16 SDLT rates		Scotland 2015/16 LBTT rates	
Band	Rate	Band	Rate
£0 - £125,000	0%	£0 - £145,000	0%
£125,001 - £250,000	2%	£145,001 - £250,000	2%
£250,001 - £925,000	5%	£250,001 - £325,000	5%
£925,001 - £1.5m	10%	£325,001 - £750,000	10%
£1.5m+	12%	£750,001+	12%

As a result of the reforms, there are substantial differences at some prices. For example, the purchaser of a £260,000 house would pay £400 less in tax in Scotland. By contrast, the purchaser of a £1.5 million house would pay £45,000 more tax under the Scottish system[25].

Estimates of Scottish yield differ from source to source - the OBR's forecasts are, for example, significantly higher than those of the Scottish Government. While the OBR originally estimated the revenue from 2015/16 Residential LBTT at £264 million, it has now revised this figure to £178 million.

The Scottish Government based its budget on an estimate of £235 million and SPICe, on the other hand, modelled an estimated £242m, with the following breakdown by band [26]:

25 OBR, Devolved Taxes Forecast, July 2015

26 http://www.scottish.parliament.uk/budget/LBTT/lbtt.html

Figure 7.6 – LBTT Yield by Band

Band	Rate	Transactions (per band)	Yield (per band) in £m
£0 - £145,000	0%	39,964	£0.0
£145,001 - £250,000	2%	26,853	£60.4
£250,001 - £325,000	5%	8,613	£45.7
£325,001 - £750,000	10%	7,919	£112.9
£750,001+	12%	595	£23.0
Total		83,944	£242.0

In the UK, the rates of property transaction duties or taxes have increased significantly over the last three decades. In modern times, stamp duty was initially almost flat and charged at two very low rates. This started changing in 1997 and gradually evolved into the system today [27]. UK tax revenues from what used to be a small charge have, consequently, increased from £675m in 1996/97 to a forecast £11.5bn in 2015/16.

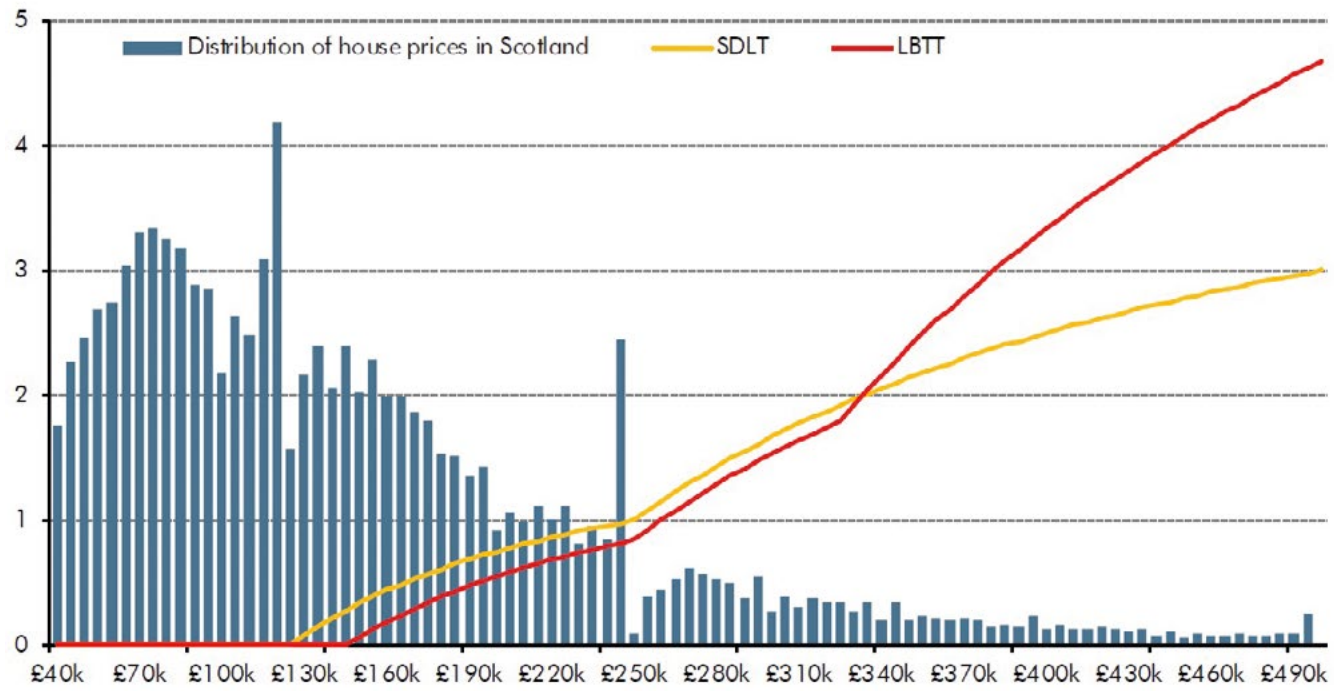
Internationally, the picture is mixed. New Zealand, for example, does not levy any property transaction taxes. USA, Canada and Australia do not levy federal taxes, but some individual states or provinces do operate transfer taxes. Other countries take even more different approaches - Japan, for example, charges sellers, while France charges both sellers and buyers of property.

27 http://www.stampdutyrates.co.uk/historic-rates.html

ISSUES TO CONSIDER

The change from SDLT to LBTT in Scotland has resulted in higher tax being levied on transactions towards the top of the property market. The difference for some transactions between the two systems runs to tens of thousands of pounds, which self-evidently increased the danger of slowing down the market - especially in areas like Edinburgh and Aberdeen, where property values are above average.

Figure 7.7 – SDLT vs. LBTT



Source: OBR, Devolved Taxes Forecast, July 2015

Recent figures from these areas provided by Savills (in Edinburgh) and ASPC (in Aberdeen) seem to confirm that transactions at the top end of the market have slowed down significantly in the first half of the 2015/16 tax year. This has a clear knock-on effect on the revenue raised, with the latest Revenue Scotland figures showing that only £96.2 million was raised in the first 6 months of the current tax year[28]. Transactions usually pick up over the summer and slow down over the winter months, which would suggest that, even accounting for forestalling in the beginning of the tax year, the Scottish Government is heading towards a considerable shortfall in projected tax revenue (budgeted at £235m).

We assessed the tax structure itself against our key principles as well as definitions of fairness and competitiveness. The graph below from the OBR was especially helpful in this task. It seems clear to us that the LBTT design is not as smooth as it should be in its progressivity and is uncompetitive compared to England.

That said, migration between rUK and Scotland is unlikely to be influenced by one-off transaction taxes - ongoing income and property taxes will have a greater bearing on this. Labour mobility within Scotland, however, will be influenced by such transaction taxes and this is discussed below.

Economic theory is pretty clear in its assessment of transaction taxes - they impact on labour mobility and significantly skew the market. The IFS, referring to its Mirrlees Review, sums up the evidence as follows:

"One of the most basic tenets of the economics of taxation is that transactions taxes should be avoided. Assets should be held by the people who value them most; the effect of a transactions tax such as SDLT is to discourage mutually beneficial transactions, so that properties are not held by the people who value them most (...) At a macroeconomic level, one manifestation of this is to reduce labour mobility, as people are discouraged from moving to where suitable jobs are available." [29]

28 Revenue Scotland, Letter to the Finance Committee, October 2015

29 IFS Green Budget 2015

Furthermore, there is no economic reason for taxing property based on the number of times it changes hands. Such a tax reduces the incentive to trade property and directly contributes to an inefficient use of housing stock[30]. This simply underlines the fact that property transaction taxes have only been used to generate revenue, with little or no consideration of the impact this would have on labour mobility or the property market.

It is important to understand the relationship between LBTT and house prices. Without adequate supply of new stock, changes in LBTT should result in directly proportionate changes in house prices. Since buyers' maximum purchasing power is a combination of house price and LBTT, without higher supply, any lowering of LBTT should increase house prices, while increasing LBTT should lower them.

This has no impact on buyers who remain willing to pay the same total price, but it does impact on sellers who get less for their property, which in turn impacts on their willingness to sell with knock-on impacts across the housing market. We are seeing some evidence of this happening in Scotland just now, with transactions towards the top of the market having slowed down considerably and those in the middle slowed down slightly.

The focus of policymakers in the housing portfolio should therefore be on minimising the distortive effects of transaction taxes, while increasing ongoing taxes on higher-value properties (as discussed below) and increasing housing supply to drive property prices down.

RECOMMENDATIONS

1. Residential LBTT as it is designed today is both uncompetitive and unfair. In the short term, it should be reformed into a non-distorting flatter charge.
2. In the longer term, Residential LBTT should be abolished.

30 Mirrlees Review, pg. 152

Air Passenger Duty

BACKGROUND

APD was recommended for devolution by the Calman Commission in 2009 as well as the Smith Commission in 2014 and is now being devolved as part of the Scotland Bill 2015/16. It is a tax that has undergone significant changes over the last decade, most noticeably a hike in rates and overall tax yield from 2007 and the partial devolution of APD to Northern Ireland in response to the Republic of Ireland's departure tax cuts.

APD was originally introduced in 1994 at a flat rate of £5 for flights to the EU and £10 elsewhere. Since then, on average, the short haul rate has risen by four-times, and the long haul rate by twenty-times, the rate of inflation[31]. The tax yield has increased over sevenfold since its first year in operation (£424m) to around £3.2 billion in 2014/15.

The most recent reforms simplified the structure to just two bands, with different rates for classes of travel:

Figure 7.8 – Air Passenger Duty Rates from April 2015

Destination Bands and distance from London (miles)	Reduced Rate (lowest class)	Standard Rate (any other class)	Higher Rate (aircraft of >20t equipped to carry <19 passengers)
Band A (0 - 2,000m)	£13	£26	£78
Band B (over 2,000m)	£71	£142	£426

Source: HMRC website

In addition, various reliefs are currently in place. The Chancellor announced relief for children under the age of 12 on economy flights to apply from April 2015, which will be extended to include children under 16. Airports in the Scottish Highlands and Islands are also excluded from the tax.

31 http://abta.com/about-us/press/air-passengers-taxed-over-27bn-in-inflation-busting-20-years-of-apd

Figure 7.9 – Departure Taxes in Europe

	Departure Tax
Germany	Band 1 - Domestic/EU/EFTA flights - €7.50 Band 2 – Not Tier 1 and under 6,000km - €23.43 Band 3 – All others - €42.18
Austria	Band 1 – Europe/North Africa - €7 Band 2 – Middle East/Africa/India - €15 Band 3 – Other long-haul - €35
Italy	Payable only on passenger flights where the aircraft is chartered for its entire capacity on an exclusive basis ("aero-taxi"). Band 1 <100km - €10 Band 2 <1500km - €100 Band 3 >1500km - €200 In addition, Italy operates a "luxury tax" on private aircraft.
France	France operates four different taxes on air travel – Civil Aviation Tax, with a Solidarity Tax surcharge, Airport Tax and Noise Pollution Tax. *Civil Aviation Tax* is levied at €4.40 for EEA flights and €7.92 for others. *Solidarity Tax* adds €1.13 (€11.27 for First Class) to EEA flights and €4.51 (€45.07 for First Class) outside EEA. *Airport Tax* adds between €7.40 and €13 depending on the airport. *Noise Pollution* rates depend on airport, aircraft and take-off time.

Source: http://www.firstchoicecarbon.com/regulation/aviation-taxes

Out of 28 EU countries, only four others levy some form of air passenger tax. Critically, those flying from UK airports pay as much as 5 times more in departure duties than if they flew from competing airports in Germany, France, Italy and Austria[32]. Belgium, Denmark, Holland, Malta, and Norway have all scrapped their APD equivalent taxes in recent years, and Germany has frozen theirs.[33]

ISSUES TO CONSIDER

The very fact that APD is considerably higher than departure taxes of other European countries, or that other countries have abolished it, is not, in and of itself, a matter for criticism. What matters is the effect this divergence might have on competitiveness. Rates of departure taxes self-evidently influence the price of flying and therefore affect decisions on taking flights on both business and leisure flights.

Most of the evidence that shows a link between APD levels and the wider economy comes from studies commissioned by airports or air travel campaigns and, therefore, their objectivity could be open to question.

Scottish Airports, for example, jointly called for APD devolution and reduction or subsequent scrapping, citing research commissioned by them. Edinburgh Airport recently conducted modelling[34] and quantified benefits based on price elasticity. The study estimated the initial benefit of reducing APD rates by 50% to be 800 jobs, rising to 1,100. The same study suggests an additional £33m in GVA, rising to £51m.

Other pieces of research in the past examined the specific impact on the tourism sector, which is of crucial importance to Scotland. A 2011 York Aviation Report[35] estimated that 148,000 trips and around £77 million in revenue would be lost in the Scottish tourism sector as a direct result of APD. Similarly, the World Travel & Tourism Council (WTTC) commissioned Oxford Economics in November 2011 to undertake an assessment of the impact of the tax on the UK economy. The research concludes that removing Air Passenger Duty would result in an increase of up to £4.2 billion in GDP and the creation of up to 91,000 jobs across the UK[36].

32 http://www.firstchoicecarbon.com/regulation/aviation-taxes
33 http://abta.com/about-us/press/air-passengers-taxed-over-27bn-in-inflation-busting-20-years-of-apd

34 Edinburgh Airport - The impact of reducing APD on Scotland's airports, March 2015
35 BAA Scotland – The impact of the 2010 APD increases in Scotland, February 2011
36 https://www.wttc.org/research/policy-research/taxes/air-passenger-duty/

Despite these studies, it has to be pointed out that the UK and Scottish tourism sector continues to flourish. The World Economic Forum's 2015 Global Travel & Tourism Report lists the UK as 137th out of 140 countries in terms of ticket tax and airport charge competitiveness. However, despite this, the UK is ranked 5th overall in tourism competitiveness - suggesting tourists are not put off by high rates of APD.

Furthermore, passenger numbers passing through Scottish airports continue to rise, with Edinburgh Airport recently recording a record number of passengers[37]. Out of all the submissions we received, only one mentioned APD: the Royal Society of Edinburgh argues that the only impact a reduction of APD would be to boost airline and airport profits.

Considering the above, we conclude that the primary need is for independent and authoritative evidence on the impact of APD policy changes. Anecdotally, and on the balance of probabilities, we believe that APD should be reformed.

RECOMMENDATIONS

1. In the short term, independent research should be commissioned to assess the impact of APD on Scotland's competitiveness.
2. In the longer term, conditional on research results, APD should be replaced by a competitive Departure Tax, with a more progressive structure linked to travel distance.

37 http://www.theedinburghreporter.co.uk/2015/11/sustained-passenger-numbers-reported-at-edinburgh-airport/

7.2.2 Local Taxes

Council Tax

BACKGROUND

Council Tax was introduced in 1993 and has since then been used to part-fund local services across Scotland as well as the rest of the UK. It is a hybrid tax with a property element and a personal element. The rate of tax payable is based on the value of residential property (as valued in 1991) with single person household discounts. It raises around £1.9 billion every year across Scotland. Domestic properties in Scotland are banded into 8 bands based on their value and the rates are derived from the tax set by individual local authorities for Band D.

Figure 7.10 – Council Tax Banding Structure

Band	Value (£) (as at 1991)	Rate of Band D	Percentage
A	Up to 27,000	6/9	67%
B	27,001 to 35,000	7/9	78%
C	35,001 to 45,000	8/9	89%
D	45,001 to 58,000	9/9	100%
E	58,001 to 80,000	11/9	122%
F	80,001 to 106,000	13/9	144%
G	106,001 to 212,000	15/9	167%
H	212,001 and over	18/9	200%

Despite the circumstances surrounding its introduction and original intention as a temporary measure, Council Tax has remained a feature of our tax system largely unreformed. As COSLA note in their submission to us, "Council Tax has provided a stable form of local taxation for well over 20 years. It is a tax that is generally well understood by local communities and has high collection levels, with a reduction and discount system in place to assist those with low incomes, disabled people, students and other groups."

Several reforms to local taxation have been examined by various commissions and advocated by political parties. In 2006, the Burt Commission recommended charging a percentage of the capital value of properties, but its findings were dismissed by the government immediately. The incoming SNP administration in 2007 planned to introduce a local income tax, but subsequently abandoned the plans. Most recently, the Commission for Local Tax Reform - a cross-party commission (with the exception of the Scottish

Conservatives who declined to participate) - reported its findings in December 2015. It concludes that council tax should be replaced, but does not recommend a specific model for change. This illustrates that local tax reform is controversial and politically challenging - chiefly because of its visibility. Our role is to be independent and non-political, but we were aware of the challenges that need to be overcome throughout our deliberations. After all, a key feature of taxes should be for them to be accepted by the public and this requires political leadership.

ISSUES TO CONSIDER

We primarily examined council tax itself and its operation, but we also looked at local taxation more generally and considered whether better alternatives exist.

We specifically considered changing the whole base of the tax (from a property tax to any alternatives) and concluded that the arguments in favour of a property-based local tax are persuasive. A tax in this form is universally accepted, easy to understand and difficult to avoid. Provided the relief system in place takes account of low income households - in high-value as well as low-value properties - we are not persuaded by the case for a local income tax. The complexities and the potential loss of transparency associated with 32 different local authorities and income taxes was of particular concern.

The old system of Domestic Rates, abolished in 1987 and replaced by the Community Charge, was such a property-based tax. It was based on the rateable value of domestic properties – an assumed annual rental income for the property. There are two main reasons why we do not advocate a return to such a system. Firstly, the rating process would be unnecessarily complex and costly, as highlighted by the assessors themselves.[38] Secondly, this complexity affects the public's understanding of the system too. Evidence suggests that property owners are much less likely to accurately calculate the rateable value of their property than, for example, its capital value.

We also considered the recommendations of the Burt Commission in 2006, which suggested local taxation remains a property tax, but is transformed into an annual charge as a percentage of the capital value of domestic properties. The main concern of such an approach would be the need for very regular revaluations (Burt Commission recommended annual revaluations), which could lead to lengthy and burdensome appeals. It would also result in varying tax rates for even the smallest of alterations. The merits of a banded structure are reflected in the public's acceptance of such a design and the miniscule number of appeals at present. We do not think the benefits of a percentage charge outweigh its disadvantages.

On balance, the experience of the council tax over the last 25 years has been positive, taking into account the nine-year freeze to correct previous above-inflation rises over a period of years, and we have not found any practical alternative from our research or from evidence given to the Commission. However, we do argue that council tax should be reformed and make recommendations that would change it into a more modern, local and fairer tax.

One of the most anomalous features of council tax is that the current banding structure is based on the value of a property as it would have been in 1991. This means that assessors today have to use complex calculations, which can be particularly difficult where significant local changes occurred over the last 25 years.

COSLA also notes that legislation does not take immediate account of improvements (e.g. extensions) to existing property: "legislation prevents the revaluation of that property until a relevant transaction, which is essentially a sale, has taken place. Once a sale has taken place then Assessors have a statutory power to revalue the property. This means that two houses of quite different values can be paying the same in council tax before any sale transaction."

A linked issue arises when considering the disproportionate rise in house prices across Scotland. The multiplier set 25 years ago - where the highest band properties attract a charge 3 times higher than the lowest band – no longer reflects the differences between properties across the scale. The Commission for Local Tax Reform, for example, estimates that if a revaluation were carried out today, properties in Band H would be worth on average 15 times more than properties in Band A.

Provided mechanisms can be found to protect cash-poor and asset-rich occupiers (e.g. deferred payments), we believe a reformed council tax will need a higher multiplier. We also considered whether additional bands would be appropriate - mirroring the approach taken in Wales in 2005. However, with Band H in

38 Burt Commission pg. 115

Scotland currently comprising only 13,000 properties (0.5% of the total) we conclude that the revenue-raising potential of introducing additional higher bands would be minimal, with no improvement in progressivity and fairness lower down the scale.

Figure 7.11 – Council Tax Property Distribution by Band

	Band A	Band B	Band C	Band D	Band E	Band F	Band G	Band H
Valuation band ranges	Under 27,000	27,001 to 35,000	35,001 to 45,000	45,001 to 58,000	58,001 to 80,000	80,001 to 106,000	106,001 to 212,000	Over 212,000
Ratio to band D	6/9	7/9	8/9	9/9	11/9	13/9	15/9	18/9
No. of dwellings	508,900	569,608	391,611	320,715	323,153	183,233	118,006	12,579
% of all dwellings	21.0%	23.5%	16.1%	13.2%	13.3%	7.5%	4.9%	0.5%

Source: Local Government Finance Statistics

Council tax has been frozen since 2007 in Scotland, providing a welcome correction, in our view, and since 2010 in England, with both governments providing funding to compensate for the freeze and prescribing various conditions that needed to be met before any increase. Recently, the Chancellor announced that English councils would be allowed to increase council tax by 2%, but only if the funding is hypothecated to social care funding.

The cost to the Scottish Government of the council tax freeze in Scotland has reached £560m in 2015/16. SPICe researchers have found that, contrary to perceptions, this funding "has resulted in local authorities receiving more income than they would have done by increasing rates by RPI."[39] Nonetheless, the decision to freeze the tax has removed virtually any ability of councils to mitigate cuts to their central grant through increased local taxation, thereby eroding the accountability link between the electorate and elected representatives.

Figure 7.12 – Council Tax Relief Schemes

Type of support	2014
All chargeable dwellings	**2,427,805**
Disability reduction	13,736
25% discount	953,612
Second homes	27,879
Long Term Empty (empty over 6 months)	31,884
Occupied entirely by disregarded adults	2,802
Dwellings not subject to discount	1,411,628
Council Tax Reduction/Benefit	533,980

One of the most important (and complex) features of council tax is the structure of exemptions, reliefs and reductions, at least one of which applies to over 1 million properties.

The Council Tax Reduction (CTR) scheme is especially important as it costs almost £360 million per year and applies to over half a million recipients across all council tax bands, as seen below:

Figure 7.13 – Council Tax Reduction Scheme by Band

Council Tax Band	Band A	Band B	Band C	Band D	Band E and above
No. of Council Tax Reduction Recipients	215,150	168,090	80,630	33,570	22,700
Share of Council Tax Reduction Households in Band	42.3%	29.5%	20.6%	10.4%	3.6%

Most of the support under the CTR scheme is targeted at the very lowest household incomes (those who rely on out-of-work benefits), with a sharper tapering off for households with incomes above their applicable amount (depending on household circumstances including number of children).

Other exemptions and discounts exist for second homes, empty properties, energy efficiency measures and a range of personal circumstances, including single occupancy, students and apprentices. We consider that these can be rationalised, with more funding targeted towards the CTR and low income households.

39 SPICe, Local Government Finance: facts and figures, 1999-2016, September 2015

RECOMMENDATIONS

1. The council tax should be reformed into a more local, fairer and progressive property tax.
2. The council tax freeze should end and rates should be allowed to change within upper and lower limits set by negotiation between local and central government.
3. The banding structure should be maintained, but the progressiveness of the multiplier should be adjusted, while protecting low income households across all bands.
4. The network of reliefs should be reviewed, with the focus on compensation for low income households across all bands.

7.3 Business Taxes

7.3.1 National Taxes

Land and Buildings Transaction Tax (Commercial)

BACKGROUND

As with residential LBTT, estimates of yield differ. While the OBR estimates tax revenues in 2015/16 to be £275 million, the Scottish Government based its budget on a £146 million figure. The OBR, however, concludes that "such are the uncertainties around estimating the fiscal effect of the introduction of new taxes that the difference between the two estimates should not be regarded as significant."[40]

Interestingly, while rest of the UK residential stamp duty rates were reformed significantly at the end of 2014, these did not extend to commercial stamp duty, which is still charged under the old slab regime. In contrast, commercial LBTT in Scotland has been reformed into a more progressive rate, in which tax is paid only on the proportion of the purchase price above the threshold. The differences are summarised below:

Figure 7.14 – Commercial SDLT and LBTT Rates

rUK 2015/16 SDLT rates		Scotland 2015/16 LBTT rates	
Band	Rate (slab)	Band	Rate
£0 - £150,000	0%	£0 - £150,000	0%
£150,001 - £250,000	1%	£150,001 - £350,000	3%
£250,001 - £500,000	3%	£350,001+	4.5%
£500,001+	4%		

In practice, due to the slab structure having been maintained in the rest of the UK, the purchase value at which buyers start paying more tax in Scotland commence at around £2 million.

ISSUES TO CONSIDER

When the new rates were announced on both sides of the border towards the end of 2014, concerns were raised over the comparatively higher differential in top marginal rate between the two countries and the impact on especially large-scale investment decisions. However, none of the evidence we received, written or oral, corroborated this. In addition, it was pointed out

40 OBR, Devolved Taxes Forecast, July 2015

that the marginal differences that do exist are largely irrelevant for investment decisions, where for example the cost of land (mostly lower in Scotland) is a much more significant factor.

This suggests to us that commercial property taxes impact more on smaller and medium-sized businesses making decisions within Scotland as opposed to investment from outwith Scotland. In its evidence to the Finance Committee's inquiry into LBTT, for example, the Chartered Institute of Taxation argued for smaller rates (1%) to encourage smaller business activity.

We made the case above for more fiscal autonomy for Scottish local authorities. Considering their control of the planning regime as well as their role in administering business rates (and powers over providing local relief), we consider commercial LBTT a good candidate for local devolution. This would not only provide an additional policy tool, but would also add a direct fiscal link between commercial development and local government. It would amplify the financial impact of business growth, providing an additional incentive to put in place competitive policies.

However, devolution to 32 local authorities would be very unbalanced[41]. Out of the 9,820 transactions subject to Commercial LBTT in 2014/15, 38% were concluded in just four council areas - Edinburgh City, Glasgow City, Aberdeen City and Aberdeenshire. The same four councils also accounted for a significant 66% (£136 million) of all the revenue raised in the same fiscal year. While local government reform is certainly outwith our remit, these significant disparities suggest to us a better way forward would be to seek a way for regional cooperation and devolution to regions. The best precedent, in our view, has been set in Scotland's strategic development planning authorities.

RECOMMENDATIONS

1. Responsibility for Commercial LBTT should be devolved to a form of regional authorities with the freedom to design their own bands, thresholds and rates. The proceeds of the tax raised would be shared by agreement among the councils comprising the regional authority.

41 HM Revenue and Customs UK Stamp Tax Statistics 2014-15

Landfill Tax

The Landfill Tax was introduced by the UK Government in 1996 to discourage the disposal of waste to landfill. When first introduced, the cost of the landfill tax was set at £7 per tonne for active waste and £2 per tonne for inert waste. The tax is currently £82.60 per tonne for active waste and £2.60 per tonne for inert waste.

Figure 7.15 – Scottish Forecast Landfill Tax Receipts

£ million	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Landfill Tax Receipts	98	99	95	104	105	105	108

Source: SPICe Landfill Tax (Scotland) Bill Briefing

Landfill Tax is a relatively non-controversial tax, which has had a considerable impact on the disposal of waste since its introduction. During the Scottish Government's consultation on a future Scottish Landfill Tax there has been consensus on the effectiveness of the tax. In terms of direct environmental impacts in Scotland, the tax has contributed to a reduction in waste sent to landfill of 59% between 2000 and 2010.

We have not received any evidence that would suggest that the operation of the tax itself or indeed the tax escalator were inappropriate in any way. We are satisfied that the transition to a devolved landfill tax went smoothly, without the introduction of additional complexity or cross-border inequities. The Commission therefore makes no recommendations on Landfill Tax.

Aggregates Levy

In 2012/13, the Aggregates Levy represented the smallest source of public sector revenue in Scotland with receipts of £45 million, accounting for 0.1% of total onshore tax receipts.

The tax was recommended for devolution by the Calman and Smith Commissions. In response to the Calman Commission recommendations, the UK Government's 2010 Command Paper said:

"Aggregates levy is currently subject to legal challenge and it would not be sensible to devolve this while issues are being considered by European Courts and the UK Government does not consider it appropriate to devolve it at this time. The Government will continue to keep the devolution of aggregates levy under review with the intention, subject to the outcome of proceedings in the European Courts, of devolving this tax to the Scottish Parliament in future."

Provisions for the devolution of Aggregates Levy have been made in the Scotland Bill 2015/16. The European Commission has reached its Phase II decision in March 2015. Towards the end of last year, the British Aggregates Association filed an appeal against this decision in the General Court in Luxembourg, which is expected to take place later this year.

We therefore consider it inappropriate to be making recommendations on the Levy at this point in time.

7.3.2 Local Taxes

Non-Domestic Rates

BACKGROUND

Non-domestic rates (NDR), also known as business rates, are a property-based tax charged to businesses and the public and third sectors based on a property's rateable value, which is normally reassessed every five years. The most recent revaluation, due in 2015, is delayed until 2017, based on 2015 property rateable values. There are three main bodies involved in the rating system: the Scottish Assessors, the Scottish Government and local authorities. The Scottish Assessors assess the rateable values of non-domestic properties. The Scottish Government sets the annual tax rate and sets out and funds the national framework for reliefs. Councils determine relief eligibility, issue NDR bills and collect payments[42].

The Scottish Parliament has since 2007/08 decided to match the poundage rate to the one applying in England. It currently sits at 48p, with an additional 1.3p large business supplement (2.6p from April 2016). Generally, the poundage rate rises annually in line with September inflation (RPI). In practice, since the Scottish budget is presented after the UK budget, the last eight years have simply followed decisions made by the Chancellor of the Exchequer.

42 SPICe, Non-Domestic Rates, June 2015

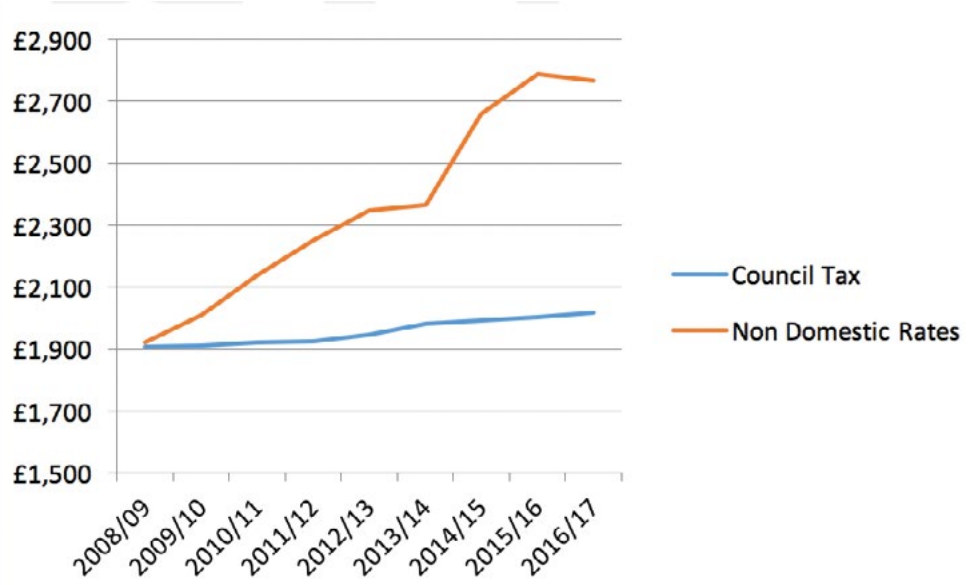
The income from non-domestic rates is currently the single largest source of revenue under the control of the Scottish Government. Non-domestic rates generated £2.37bn in 2013/14.

Provisional outturn for NDRI in 2014/15 is £2.66bn and estimated NDRI in 2015/16 is £2.84bn[43]. The Scottish Retail Consortium have argued that the sharp increase in NDR revenue since 2007/08 places a disproportionate burden on businesses in providing local authority finance since "there has been a 42 per cent increase in revenue derived from business rates but only a 7 per cent increase in council tax." [44]

43 Ibid.

44 Scottish Retail Consortium, Holyrood 2016: Business Rates, August 2015

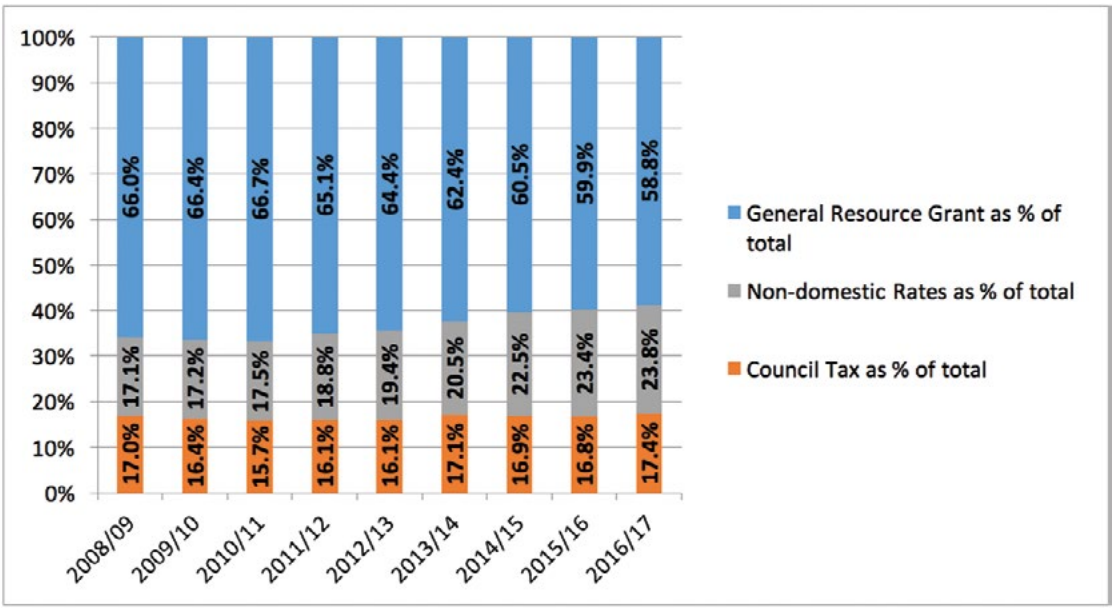
Figure 7.16 – Rise in Non-Domestic Rates Receipts Since 2008/09



Source: OBR, Devolved Taxes Forecast, July 2015

NDR needs to be put in the context of overall local authority budgets to see more precisely how the share of individual taxes has increased. The chart below shows that recent years have seen a gradually higher share of council revenue come from non-domestic rates, with general revenue funding falling.

Figure 7.17 – Change in Non-Domestic Rates as a Share of Council Revenue



2014/15 figures are provisional 2015/16 and 2016/17 figures are planned
Does not include "other income" and "customer and client charges"
Source: Local Government Financial Statistics and Circulars

ISSUES TO CONSIDER

Recent years have seen an increase in the number of calls for the reform of business rates. In Scotland, five major business groups advocate business rate reform or replacement - SRC, CBI Scotland, FSB Scotland, IoD Scotland and the SCDI. These organisations have been highlighting a series of problems with the way the tax operates as well as broader issues with taxing business property in a modern economy and the rise of 42% in rates payable since 2007/08. In recent months, various business representative organisations have raised increased concerns, in Scotland and rUK, that the level of business rates is now putting the UK's business competitiveness at serious risk.

We can see merit in some of the proposals made by Scottish business organisations regarding business rate reform (as distinct from replacement). We agree that more frequent revaluations could make the system more responsive to changing economic conditions as well as with the need to simplify the collection and billing of rates. The existence of 14 separate assessors - especially in light of there only being one in England - seems unnecessary too and none of the evidence we received justified the retention of this approach.

The network of business rate reliefs that has developed over decades is particularly convoluted. Recent legislation (Community Empowerment and Renewal Act) extends these even further by enabling local authorities to create individual relief schemes too - provided they are all fully funded. These schemes could be used to provide targeted relief to individual businesses, particular industries, local areas or even the whole local authority area. While we believe this is a welcome development, it adds even further complexity to the relief system.

Figure 7.18 – Non-Domestic Rates Reliefs

	2013/14	% of total
Unoccupied Property/Partly Unoccupied Property	146,496	24.85%
Charities	173,623	29.45%
Sports Clubs	12,911	2.19%
Disabled persons relief	58,299	9.89%
SBBS	161,002	27.31%
Religious Properties	25,205	4.28%
Rural Rate Relief	4,323	0.73%
Renewable Energy Relief Scheme	7,333	1.24%
New Start	130	0.02%
Fresh Start	189	0.03%
Other	63	0.01%
Total Amount	589,574	100.00%

Source: Local Government Financial Statistics

The Small Business Bonus Scheme has attracted the most attention in Parliament. It is the second largest relief and is projected to provide relief to over 99,000 small businesses in the year 2015/16. The scheme is lauded by small business organisations, but its design (100% under £10,000 RV, 50% under £12,000 RV, 25% under £18,000 RV) is not progressive. Furthermore, the scheme takes no account of the levels of employment by businesses in receipt of the relief and we have received anecdotal evidence that it can be prohibitive to small business growth.

Business organisations, however, are calling for more than a review of reliefs or tweaks to the operation of the present system. They argue that a fundamental change to the businesses rates system is necessary to address some of the inequities of the system. Firstly, the system does not reflect growth in business without change in property. Secondly, the system disadvantages certain business sectors over others - in particular retail as a property-heavy sector. Thirdly, the system does not fully capture the rise of the weightless economy, putting businesses with premises at an inherent disadvantage.

None of the evidence we received provided specific suggestions of solutions to these inequities. There are good reasons for levying a business property tax (it is hard to avoid, it provides a link to council services), but we do recognise that some reform is desirable.

We have also considered the call made by COSLA and others for a localisation of business rates and a return to the days before the introduction of the Uniform Business Rate. Whilst we understand and endorse the case for more local fiscal levers, there are two fundamental reasons for why our final recommendations reject full business rate localisation.

Firstly, we believe the current local government structure is prohibitive to such fiscal devolution. Regional rates policy reflecting regional economic differences would be reasonable, but fragmenting the system into 32 separate business rate regimes would add complexity to the system without any resulting policy coherence. Furthermore, the large disparity in business rate income per head between councils shows the need for pooling and sharing, which would not be as pronounced under a regional structure.

Secondly, in the absence of corporation tax devolution, non-domestic rates are the primary business tax available to the Scottish government and should therefore remain a centrally-controlled one.

There is, however, scope for more local control. While the new Community Empowerment Act technically allows giving discounts to all businesses within a local area, a more explicit change should be legislated for, which would allow local authorities to vary the poundage rate up or down within centrally-set limits and conditional upon thorough business consultation.

In line with our recommendations on Commercial LBTT, provided a regional structure or a form of regional cooperation were to be developed, further devolved control of non-domestic rates to councils should be considered, with the retention of an element of central control. This could be done by reforming business rates into a system of shared taxation between the Scottish Government and regional government.

RECOMMENDATIONS

1. Revenue Scotland should take over the responsibility for the collection and billing of non-domestic rates.
2. The number of assessors should be reviewed to optimise consistency across Scotland.
3. Introduce more frequent revaluations (at least every 3 years) of business property.
4. Freeze business rates at least until the end of the next Parliament to partially offset the 42% rise since 2007/08 and increasingly move towards a more competitive rate of tax.
5. Any future inflationary increases to the poundage rate, beyond the recommended freeze, should be based on a maximum of the CPI - the UK Government's default indexation benchmark for social security benefit rates - as opposed to the normally higher RPI.
6. The poundage rate should continue to be set by central government, but local authorities should also have a discretionary power to increase or decrease rates locally with limits set by central government.
7. The NDR relief structure should be reviewed and targeted at incentivising employment and investment.
8. In the longer term, the Scottish Government should conduct a structural review to explore the replacement of non-domestic rates with a possible tax sharing arrangement between central government and regional authority partnerships.

7.4 New Taxes

Our Call for Evidence made it clear that we would consider the creation of new taxes and not just look at the existing basket of taxation. There are several new taxes that have been recently discussed in a Scottish or UK setting. For example, arguments have been put forward for and against a "sugar tax" aimed at improving public health and reducing the cost burden on the NHS, with conflicting evidence as to the effectiveness of such a policy in achieving those goals.

Recently, local authorities made the case for so-called tourist/event taxes and congestion charges in Scotland's major cities. A charge levied on nightly stays is very common in European tourist destinations, sometimes levied specifically during popular events (like the Edinburgh Festivals). Congestion charges have over the last two decades become not only a revenue-raising measure to ameliorate the cost burden of heavy traffic, but an environmental policy tool aimed at improving air quality by reducing traffic in big cities.

We do not advocate the introduction of these measures as taxes, but we do see why some local authorities would reasonably want to levy them. It hasn't escaped our notice that recent events on the Forth Road Bridge have caused some to criticise the abandonment of tolls in Scotland. As with the above, we can see the pros and cons of such an approach, especially in the case of estuarial crossings like the Old and New Forth Road Bridges that are expensive to build and maintain. Road tolls are a common way of raising revenues in most European countries and with new technology the cost of implementing such charges is much reduced against manually operated toll-booths.

We are also conscious of the now global agreement to reduce carbon emissions and the fact that Scotland's emissions, which have benefitted from the reduction in heavy industry and elimination of coal burning power stations, may be more difficult to reduce in the future. But we have empathy with the recent ruling from the EU Court of Justice. Restrictions on market competition should be avoided if there are other ways of achieving the desired policy aim.

Fundamentally, the crucial factor in determining the pros and cons of new taxes must be good research and solid evidence. Often the aims of a new tax or charge are admirable, but the unintended consequences of the policy render it ineffective. Consequently, we have agreed that any new taxes or service charges should:

- Not increase the overall tax burden on disposable income;
- not place restrictions on market competition;
- be based on good research and solid evidence;
- and should only be instigated if there is no other way to achieve the policy aim.

8. SPENDING, REGULATORY AND BORROWING POWERS

The focus of our work has been taxation and its role in delivering a competitive and fair Scotland. Our Call for Evidence, however, also included broad considerations on Scottish public spending. We did not have the remit, the capacity nor the time to undertake a zero-based review of public spending, but we did examine the evidence on wider patterns seen over recent years.

We have deliberately focused on those areas of public spending and policy that we identified as most conducive towards achieving the priorities identified above. Ultimately, we know that most policy decisions - on taxation as well as spend - are of a political nature, based on goals which can be selected for a range of reasons. Policy emphasis therefore depends on political priorities. Our recommendations are made in pursuit of a competitive and fair system of taxation in which politically designed policies can be implemented.

Figure 8.1 - Total Proposed Scottish Budget for 2016/17

	DEL Resource	DEL Capital	DEL Total	AME	Total
Health, Wellbeing & Sport	12,443.8	494.5	12,938.3	100.0	13,038.3
Finance, Constitution & Economy	378.9	256.3	635.2	3,441.6	4,076.8
Education and Lifelong Learning	2,375.0	99.5	2,474.5	379.3	2,853.8
Fair Work, Skills and Training	252.5	0.0	252.5	0.0	252.5
Justice	2,437.5	74.8	2,512.3	0.0	2,512.3
Social Justice, Communities & Pensioners' Rights	6,960.0	1,319.5	8,279.5	2,768.5	11,048.0
Rural Affairs, Food & the Environment	498.0	62.4	560.4	0.0	560.4
Culture, Europe & External Affairs	212.0	31.7	243.7	0.0	243.7
Infrastructure, Investment & Cities	1,012.7	1,127.2	2,139.9	0.0	2,139.9
Administration	179.9	13.1	193.0	0.0	193.0
Crown Office & Procurator Fiscal	108.9	3.6	112.5	0.0	112.5
Scottish Parliament and Audit Scotland	100.6	1.7	102.3	0.0	102.3
Total	**26,959.8**	**3,484.3**	**30,444.1**	**6,689.4**	**37,133.5**

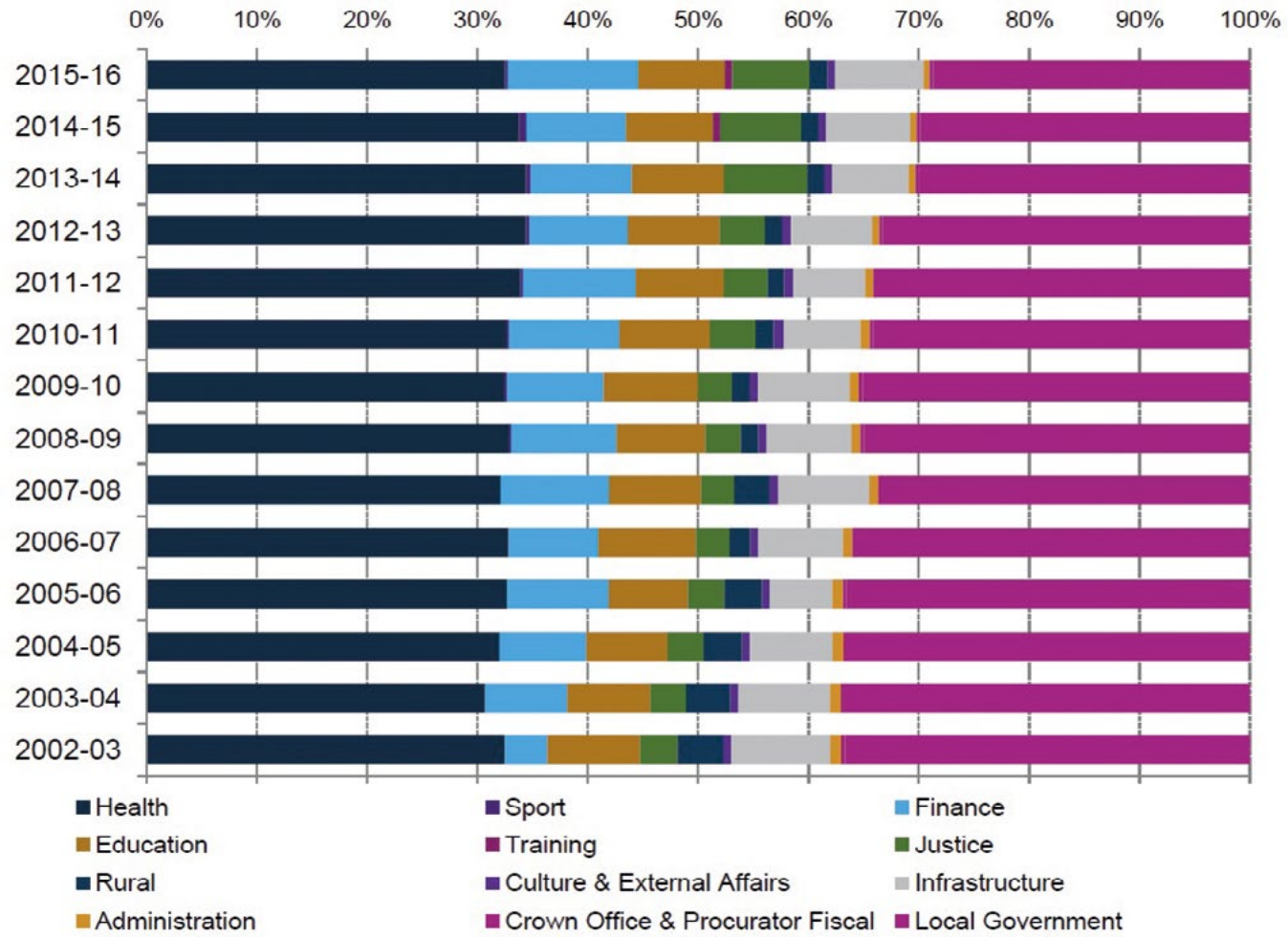
Source: Scottish Government Draft Budget 2016/17

8.1 Scottish Budget

The total Scottish budget for devolved spending has reached £37 billion in 2016/17, with the discretionary element (DEL) reaching £30 billion. The following table shows a breakdown of budget allocations to individual portfolios and their share of the overall budget.

These public spending patterns have changed only marginally over the last decade or so. The table below shows that health spending, for example, has consistently remained one of the largest items of the Scottish budget, with recent decreases in the local government portfolio.

Figure 8.2 – Share of Total Managed Expenditure by Portfolio



Source: SPICe, Budget Scrutiny, SB14-73

Much of the Scottish budget is identified by SPICe as "largely fixed commitments", which include pay/staff costs (£14.5bn), pensions (£3bn), infrastructure/asset management (£3.4bn) and NHS prescribing costs (£1.4bn). Once these commitments are stripped out, there is limited scope for discretionary changes in the budget. This again underlines the importance of new revenue-raising powers, which present both risks and opportunities in public policy making.

Patterns of public spending in Scotland have been analysed regularly across a series of commissioned reports. While the conclusions have often been the same, there has been little substantive progress in implementing the difficult structural changes that have been recommended. We have revisited the Beveridge and Christie reports and have found little in them to disagree with. Both reports urge decision-making based on long-term outcomes and not short-term political imperatives - a sentiment which we wholly endorse and one we employed during our consideration of our report.

As an overarching point, we believe the public sector in Scotland does need a structural and operational re-evaluation envisaged by Beveridge and Christie and confirmed by a whole host of reports on public sector spending procedures.

Figure 8.3 – The Cost of Universal Services

Council Tax Freeze	£560m
Free personal Care	£400m
Concessionary Travel	£197m
Prescription Costs	£62m
Free Tuition	£220m
NHS Eye Examination	£67m
NHS Dental Examinations	£24m

Source: SPICe, Budget Scrutiny, SB14-73

Our attention has been drawn to a relatively recent feature of Scottish public policy - an increase in the budgets for universal service provision. The case for fully funded public programmes rests on the wider benefit and importance of such programmes to society

as a whole. For example, we all benefit from an educated and healthy population. Not all services are fully funded and charges are levied to reduce the cost and reflect demand for services – such as leisure facilities or planning controls - where the benefits are mixed. We were surprised to find growth of universal provision of services which had partial charges in the past, whilst core services were being cut.

It is particularly difficult to reduce such benefits once introduced, but it is difficult to understand why these programmes should be protected when other major services and economic development programmes face larger reductions as a result.

This was also a conclusion reached by the Beveridge Independent Budget Review, which was specifically tasked to examine the long-term sustainability of public services in Scotland. Beveridge concludes that "the principle of universality in the delivery of many of our public services (...) is commendable, but simply may no longer be affordable. A debate needs to be had on whether those who can afford to pay might be invited to do so, thus allowing better targeting of those in most need." We endorse this conclusion.

Furthermore, successive governments have decided to "ring-fence" specific portfolios. In Scotland, this has recently been applied to health spending and, following the Paris terrorist attacks, police budgets, but in England the approach extended to ever more protected departments - NHS, schools and overseas aid. While ring-fencing is politically attractive, it is a crude approach that does not take any outcomes into account. Nor does it encourage innovation or the elimination of inefficiencies in service delivery. Indeed, the Beveridge Report concluded that there is "no overwhelming rationale for protecting major blocks of expenditure, particularly in the context of integrated services and early intervention programmes."

Within the Scottish budget and the budgets of local authorities, endorsing the broad findings of the Beveridge and Christie reports, we recommend that priority be given to investment in supply side measures that will assist over time in improving Scotland's economy and competitiveness:

- Transport and connectivity, including digital connectivity;
- Education and skills;
- Support for research, development and innovation;
- Clean and affordably energy and water;
- Health improvement;
- A responsive planning system;
- Economic development and business and entrepreneurial support by SE, HIE and local authorities;
- Support for exporters and inward investment.

8.2 Budget Scrutiny and Transparency

The accurate reporting of anticipated links between policy decisions and outcomes, as well as an evaluation of the effectiveness of these policy choices towards achieving outcomes is an issue that needs addressed. This becomes even more important following the significant devolution of further powers to the Scottish Parliament. To use a direct comparison, there is a striking difference between Scottish budget documents and the analysis provided by the OBR alongside HMT budgets.

This lack of transparency in official documents directly contributes to difficulties in holding the government to account by opposition parties as well as the media and the general public. This in turn translates into a general lack of awareness of policy levers available to the Scottish government and the policy outcomes linked to their use. This broken accountability link is one of the biggest policy challenges in Scotland. We therefore believe that improved transparency must be at the heart of the new devolved settlement. This should include the preparation of audited Whole of Government Accounts, as recommended by the Royal Society of Edinburgh in their submission to us.

The nature of Scottish devolution and the role of the block grant and the Barnett formula in relation to the Scottish budget are poorly understood and virtually impossible for the public to access. We do believe that a more transparent and accurate reporting of revenue flows should become a feature of both UK and Scottish budgets.

The reliance on accurate fiscal projections for policymakers requires that rigorous and politically independent work be undertaken ahead of annual budget decisions. Again, this becomes exponentially more relevant in Scotland with the devolution of significant tax powers. The Scottish Government established a Scottish Fiscal Commission, which is currently being codified in legislation through a Bill laid before the Scottish Parliament. While some of the main criticisms of the non-statutory SFC are being partially addressed in the Bill (its resourcing, independence and

limited scope), there is still some way to go to achieve the standards that the Office for Budget Responsibility established over the last 5 years.

The SFC's independence should be of paramount importance. The current Bill still leaves appointments to Ministerial discretion. We agree with Jeremy Peat from the IPPI in that to put the SFC's independence beyond any doubt, any appointments should be made transparently and approved by the Scottish Parliament's Finance Committee[45].

The second main point of debate has been the scope of the proposed SFC's powers. Currently, the SFC only provides commentary on Scottish Government fiscal projections and assesses whether they are reasonable. The Bill extends this scope to the production of annual reports laid before Parliament. Most professional economist[46] giving written and oral evidence to the Finance Committee agree that the ideal role of the SFC would be to produce independent forecasts, which would be binding on the Scottish Government. During these evidence sessions it was made clear that there is a considerable difference between independent direct forecasting and independent assessment of the Scottish Government's forecast. To quote Peat, "it is during 'hands on' forecasting work that a strong understanding of the key factors to which forecasts are sensitive becomes apparent." [47]

RECOMMENDATIONS

1. A structural review of public sector agencies should be undertaken, in line with the Beveridge and Christie reports, with the overarching aims of improving collaboration, efficiency and sustainability.
2. The Scottish Government should exercise a more rigorous approach to budget reporting, outlining how policy proposals advance its strategic objectives, their cost and anticipated outcomes.
3. Whole of Government Accounts for Scotland should be compiled, kept up to date and made easily accessible.
4. Reporting on revenue flows, especially in relation to block grant calculations, deductions and devolved taxes, should be significantly improved on both Scottish and UK levels.
5. The Scottish Fiscal Commission appointments should be transparent and approved by the Scottish Parliament's Finance Committee.
6. The SFC should be tasked with producing official economic forecasts, together with debt and borrowing projections

8.3 Borrowing and Infrastructure Investment

Borrowing powers were extended in the Scotland Act 2012. The Scottish Government is able to borrow an amount equivalent to 10% of its capital budget in each year, provided that the cumulative stock of capital borrowing does not exceed £2.2bn. The assumed repayment periods are 25 years with a 5% interest rate. The Scottish Government has decided to borrow the maximum for 2015/16 - £304m.

This, of course, is only a fraction of the total borrowing powers across the public sector. Private Finance Initiative (PFI) projects, more recently repackaged as Non-Profit Distributing (NPD) schemes, have been used by both central and local government for decades. In April 2014, SPICe researchers estimated that the total combined revenue-financed liabilities across the public sector stood at £35.3 billion, of which 18% had been repaid[48]. The following table provides a breakdown of these liabilities by sector.

45 IPPI, Scottish Fiscal Commission Policy Brief, November 2015
46 Prof Jeremy Peat, Dr Angus Armstrong, Prof Ronald MacDonald, Prof Peter McGregor, Prof Kim Swales, Dr Katerina Lisenkova
47 IPPI, Scottish Fiscal Commission Policy Brief, November 2015
48 SPICe, Revenue-financed investment: the size of Scotland's PFI and NPD liability, April 2014

Figure 8.4 – Total Revenue-Financed Liabilities

Sector	Number of Projects	Payments made by 2012/13 (£m)	Charges (£m)	Total (£m)
PFI				
Energy	1	43.0	86.9	129.8
Hospitals and Acute Health	27	1,436.9	6,562.9	7,999.8
IT Infrastructure and Communications	1	25.6	0.0	25.6
Offices	1	34.0	40.5	74.6
Prisons	2	319.0	993.0	1,312.0
Roads and Highway Maintenance	4	576.6	1,874.7	2,451.4
Schools	34	2,394.1	11,632.4	14,026.5
Waste	11	1,490.5	3,270.4	4,760.9
Other	2	68.7	87.0	155.6
Total	**83**	**6,388.4**	**24,547.8**	**30,936.1**
NPD				
Further Education	2	0.0	741.0	741.0
Health	4	9.5	561.8	571.3
Schools	5	163.9	1,499.1	1,662.9
Transport	1	0.0	1,391.1	1,391.1
Total	**12**	**173.3**	**4,193.1**	**4,366.4**
PFI & NPD				
Total	**95**	**6,561.7**	**28,740.9**	**35,302.5**

Source: SPICe, Revenue-financed investment: the size of Scotland's PFI and NPD liabilityScrutiny, SB14-73

Based on these existing projects, without taking into account any future liabilities, annual payments are expected to peak in the financial year 2025/26 at around £1.2 billion per year.

One of the key features of the fiscal framework negotiations are decisions over borrowing limits. These are on-going and we therefore cannot comment on the specific borrowing regime that will be available to the Scottish Government. In any case, it would be outwith our remit to suggest precise borrowing limits. As with tax and spend, these are primarily decisions of a political nature.

That said, we do recognise that the use of borrowing powers can unlock significant investment in infrastructure. In spite of the fact that the Scottish Government produces a comprehensive Planning Framework which identifies National Infrastructure and regionally important projects, infrastructure decisions are an ongoing subject of controversy and political debate. The SCDI, for example, argues for a separate Infrastructure Commission to be set up, which would make binding recommendations on infrastructure priorities to the Scottish Government. A similar approach was recently taken in England. We considered this approach and believe that it would be inappropriate and unaccountable to outsource decisions of this magnitude away from elected representatives.

However, we see merit in significantly improving the transparency surrounding the debt structure across the public sector. A principal cause of over-spends on infrastructure projects has been the intention to agree a deal to satisfy a political decision on the importance of a project before its true cost is known. This attitude manifestly leads to the taxpayer being burdened with the risk of cost over-run. Whether or not the borrowing arrangements and long-term liabilities are as prudent as they should be is not transparent.

With interest rates at an all-time low the UK Treasury enjoys favourable bond yields backed by strong economic performance. This will not continue indefinitely in an economic cycle which produces periods of recession. We believe the nature of the Scottish economy as described above requires public bodes to be cautious as well as prudent in the amount of debt they enter into.

It needs to be borne in mind that borrowed money is not new money; it is money that needs to be repaid. The wider fiscal framework will include borrowing limits that will be deemed affordable on a UK-wide basis. We do believe, however, that the Scottish Government should adopt its own separate criteria for its borrowing rather than simply using borrowing powers to the maximum available limits.

The long-term cost of servicing these liabilities might prove to be a significant element of the Scottish budget. The Scottish Government in 2011 indicated that cumulative annual payments would not exceed 5% of its annual DEL budget, but it is not bound by this and reporting on this commitment is not transparent. We therefore believe that the Scottish Parliament should put in place regular reporting measures to ensure proper scrutiny.

RECOMMENDATIONS

1. The debt structure across the whole Scottish public sector should be made significantly more transparent.
2. Scottish public bodes should be cautious as well as prudent in the amount of debt they enter into.
3. Annual reporting on the government's borrowing target, levels of debt and interest payments should be introduced and published alongside the Scottish Budget.

9. CONCLUSIONS

Our recommendations are based on the assumption that the Smith taxation powers will be enacted by the UK Parliament, and with the Scottish Parliaments consent, in the interests of all of Scotland's population and businesses. Not only will these powers have a direct and indirect impact on Scottish based businesses – wherever registered - but they can and should be used to create, attract and retain skilled employees and highly mobile foreign investors.

Chapter 6 – The Scottish Economy catalogues some of the dependencies, issues and challenges that policymakers need to overcome. We believe that the range of powers at the disposal of the Scottish Government should be used to create an economic environment in which a) Scottish businesses grow in size and number, b) skills align with demand and further talent is attracted to - and retained in - Scotland, and c) transparency and accountability improve across all tiers of government.

While there are difficulties with attempting to analyse the impact of tax changes on the Scottish economy, not least because taxation is just one policy consideration, it seems clear to us that the taxation policy focus should be on income tax and non-domestic rates - both by far the largest of Scottish taxes on individuals and businesses respectively.

Scotland's position on the geographic periphery of Europe has to be reflected in these policy decisions. One of our key recommendations therefore is that Scotland's overall tax burden should not be higher than that of our nearest competitors.

In addition, it is widely felt that there is a lack of transparency both in the budget process and the design of tax powers, leading to weaker accountability to voters. Improved transparency must be at the heart of the new devolved settlement.

We believe that our recommendations as a whole would achieve the necessary progress towards the three objectives we identified and help turn Scotland into a dynamic country that is both more competitive and fairer than it is today.

a) Scottish businesses grow in size and number

Non-domestic rates are de facto the largest business tax under the Scottish Government's control. The tax has accounted for an increasing share of local government finance and we received compelling evidence in support of reform and a reduction of the burden on business.

We recommend freezing business rates for at least the duration of the next Parliament alongside several reforms that would optimise and harmonise the system. We believe the business rates relief system should be recalibrated to support higher employment and investment.

In the longer term, we believe a structural review should be undertaken to explore the replacement of business rates with a system that takes into account the rise of the weightless economy as well the potential for a more localised approach.

We see merit in enhancing regional cooperation between local authorities in pursuit of a cohesive approach to regional economic development. Our recommendations on Commercial LBTT would allow grouped local authorities to use the lever to attract businesses into the region and support further expansion.

We considered calls for APD reform and conclude that the primary need is for independent and authoritative evidence on the impact of APD policy changes. In the longer term, conditional on research results, we recommend that APD should be replaced by a competitive Departure Tax, with a more progressive structure linked to travel distance.

b) Skills align with demand and further talent is attracted to - and retained in - Scotland

The lack of skills in particular industries has been highlighted to us and while much of the progress that is necessary in this area will depend on education and training policy, the taxation system does play a very important role too. Not only is income tax the major source of Scottish devolved tax revenue – almost equal to all other devolved taxes – it is also the major tool in the Scottish Government's hands to attract and retain skills against global challenges.

The evidence on taxpayer mobility points very clearly to the approach that should be taken on devolved income tax in Scotland. Due to the very small number of additional rate taxpayers in Scotland, any significant increase in personal taxes could be counter-productive.

The top rate of income tax should therefore not be higher in Scotland than in our nearest competitors at any given time. We also recommend an additional band sent between the basic and higher rate to make income tax progressivity smoother - primarily to improve the incentives for workers moving towards the higher rate and attracting the professional and technical skills that can take years to develop.

Attracting skilled immigration as well as removing barriers to inward mobility of labour are in our judgement an important consideration for the Scottish Government when designing its taxation policy. Residential LBTT as it is designed today is both uncompetitive and unfair.

In the short term, we recommend it should be reformed into a non-distorting flatter charge and in the long term it should be abolished.

Transaction taxes are one of the worst kinds of taxes and in relation to property in particular, ongoing taxes on use should be preferred. To that end we recommend the council tax should be reformed into a more local, fairer and progressive property tax.

c) Transparency and accountability improve across all tiers of government

Complex tax structures and vast networks of reliefs not only take up taxpayers' time, but put a strain on the accountability link between elected representatives and voters.

A key recommendation is that in designing new taxes and reforming existing ones, the focus should be on minimising complexity for taxpayers. Reliefs and exemptions should be kept simple and taxes should be transparent, predictable and easy to understand for both business and personal taxpayers.

We are also making recommendations that would transfer powers from central government to a more local level, with more control over personal and business taxation for local authorities - either individually or in cooperation within regions. This would help address the present lack of local accountability of elected councillors.

The lack of transparency is also a serious issue in the Scottish budgeting process. We make a series of recommendations in this area, including a call for a more rigorous approach to budget reporting, compilation of Whole of Government Accounts for Scotland and an improved reporting on revenue flows - especially in relation to block grant calculations, deductions and devolved taxes.

The establishment of a Scottish Fiscal Commission, and the subsequent moves to put it on a statutory footing are welcome. However, progress should be made in two areas - appointment of its membership and its remit.

We are also calling for annual reporting on the government's borrowing target, levels of debt and interest payments.

Fundamentally, the debt structure across the whole Scottish public sector should be made significantly more transparent.

10. LIST OF RECOMMENDATIONS

- In designing new taxes and reforming existing ones, the focus should be on minimising complexity for taxpayers. Reliefs and exemptions should be kept simple.
- A low target administration percentage should be set, monitored and reported on.
- Taxes on income should be progressive and be relatively smooth throughout the scale.
- Taxes should be transparent, predictable and easy to understand for both business and personal taxpayers.
- Scotland's overall tax burden should not be higher than that of our nearest competitors.
- Scottish taxes should be designed to retain and attract the skilled people consistent with delivering our aspirations for a fair and competitive economy and society.
- Given the very small number of additional rate taxpayers in Scotland, any significant increase in personal taxes could be counter-productive. The top rate of income tax should not be higher in Scotland than in our nearest competitors at any given time.
- A new (circa 30%) income tax band should be introduced between 20% and 40% to make income tax progressivity smoother. The thresholds for the band should not be used to increase income tax on basic rate taxpayers.
- Policymakers should be wary of increasing the personal allowance above rUK levels via the introduction of a nil rate band as this could have significant consequences on Scotland's budget due to a further narrowing of the tax base.
- Residential LBTT as it is designed today is both uncompetitive and unfair. In the short term, it should be reformed into a non-distorting flatter charge.
- In the longer term, Residential LBTT should be abolished.
- In the short term, independent research should be commissioned to assess the impact of APD on Scotland's competitiveness.
- In the longer term, conditional on research results, APD should be replaced by a competitive Departure Tax, with a more progressive structure linked to travel distance.
- The council tax should be reformed into a more local, fairer and progressive property tax.
- The council tax freeze should end and rates should be allowed to change within upper and lower limits set by negotiation between local and central government.
- The banding structure should be maintained, but the progressiveness of the multiplier should be adjusted, while protecting low income households across all bands.
- The network of reliefs should be reviewed, with the focus on compensation for low income households across all bands.
- Responsibility for Commercial LBTT should be devolved to a form of regional authorities with the freedom to design their own bands, thresholds and rates. The proceeds of the tax raised would be shared by agreement among the councils comprising the regional authority.
- Revenue Scotland should take over the responsibility for the collection and billing of non-domestic rates.
- The number of assessors should be reviewed to optimise consistency across Scotland.
- Introduce more frequent revaluations (at least every 3 years) of business property.
- Freeze business rates at least until the end of the next Parliament to partially offset the 42% rise since 2007/08 and increasingly move towards a more competitive rate of tax.
- Any future inflationary increases to the poundage rate, beyond the recommended freeze, should be based on a maximum of the CPI - the UK Government's default indexation benchmark for social security benefit rates - as opposed to the normally higher RPI.
- The poundage rate should continue to be set by central government, but local authorities should also have a discretionary power to increase or decrease rates locally with limits set by central government.
- The NDR relief structure should be reviewed and targeted at incentivising employment and investment.
- In the longer term, the Scottish Government should conduct a structural review to explore the replacement of non-domestic rates with a possible tax sharing arrangement between central government and regional authority partnerships.
- A structural review of public sector agencies should be undertaken, in line with the Beveridge and Christie reports, with the overarching aims of improving collaboration, efficiency and sustainability.
- The Scottish Government should exercise a more rigorous approach to budget reporting, outlining how policy proposals advance its strategic objectives, their cost and anticipated outcomes.
- Whole of Government Accounts for Scotland should be compiled, kept up to date and made easily accessible.

- Reporting on revenue flows, especially in relation to block grant calculations, deductions and devolved taxes, should be significantly improved on both Scottish and UK levels.
- The Scottish Fiscal Commission appointments should be transparent and approved by the Scottish Parliament's Finance Committee.
- The SFC should be tasked with producing official economic forecasts, together with debt and borrowing projections
- The debt structure across the whole Scottish public sector should be made significantly more transparent.
- Scottish public bodes should be cautious as well as prudent in the amount of debt they enter into.
- Annual reporting on the government's borrowing target, levels of debt and interest payments should be introduced and published alongside the Scottish Budget.

11. SUBMISSIONS RECEIVED

The below is a list of written submissions which the Commission received in response to its initial Call for Evidence. It does not include respondents who wished to remain private. Some of these submissions were followed up by further oral evidence sessions.

AGCC
Andrew Morrison
Brian Cram
CBI Scotland
Chartered Institute of Taxation
CIPFA
Comhairle nan Eilean Siar
COSLA
David Mitchell
David Stark
Derek Murray
EY
East Ayrshire Council
Fiona Rice
FSB
ICAS
Inverclyde Council
IRRV
Jimmy Reid Foundation (Dr and Mrs Cuthbert)
Kathleen Shand
KPMG
Luke Warren
Malcolm Parkin
Reform Scotland
Robert Miller-Bakewell
Royal Society of Edinburgh
Scottish Futures Trust
Scottish Property Federation
Scottish Retail Consortium
Sylvia Cartwright

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