



FINANCE COMMITTEE

AGENDA

12th Meeting, 2013 (Session 4)

Wednesday 24 April 2013

The Committee will meet at 9.30 am in Committee Room 2.

1. **Decision on taking business in private:** The Committee will decide whether to take item 3 in private.
2. **Scotland Act 2012:** The Committee will take evidence on the implications of the financial powers arising from the Scotland Act 2012 from—

Professor Gerald Holtham, Chair, Independent Commission for Funding and Finance for Wales;

and then in a round-table format from—

Jeremy Peat, Director, The David Hume Institute;

David Bell, Professor of Economics, University of Stirling;

David Ulph, Professor and Head of School of Economics and Finance, St Andrews University;

Drew Scott, Professor of European Union Studies, University of Edinburgh;

John McLaren, Centre for Public Policy for Regions, University of Glasgow;

Ken Gibb, Professor in Housing Economics, University of Glasgow.

3. **Landfill Tax (Scotland) Bill:** The Committee will consider its approach to the scrutiny of the Bill at Stage 1.

FI/S4/13/12/A

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The papers for this meeting are as follows—

Agenda item 2

Paper by the clerk

FI/S4/13/12/1

Agenda Item 3

PRIVATE PAPER

FI/S4/13/12/2 (P)

Finance Committee

11th meeting (Session 4), Wednesday 24 April 2013

Scotland Act 2012

Introduction

1. At its meeting on 12 December 2012 the Committee agreed to take further evidence on the implementation of the Scotland Act 2012 including on the adjustment of the block grant following the devolution of further financial powers. The Committee further agreed to submit its views on the adjustment of the block grant to the Scottish Government by the end of May 2013 in order to inform the discussions of the Joint Exchequer Committee.

2. At its meeting on 24 April the Committee will hear from Professor Gerald Holtham, Chair, Independent Commission for Funding and Finance for Wales (Holtham Commission). Professor Holtham has provided a briefing note on the principles for distributing and adjusting a block grant around the UK and this is attached. This session will focus on the block grant adjustment mechanism in relation to the Scottish rate of Income Tax (SRIT) which is due to be introduced from April 2016.

3. The Committee will then take evidence in a round table from the David Hume Institute. The first part of this session will continue the discussion on adjusting the block grant and will be led by the Budget Adviser who has produced a briefing note which is also attached. The second part of this session will focus on the economic and financial implications of the Scotland Act 2012 and finally the impact of the new powers on the parliament's scrutiny function. For example, what scrutiny role should the Finance Committee have in relation to the devolved taxes, SRIT and borrowing? What is the impact on the budget process? What role should the Committee have in relation to the reconciliation of forecast tax receipts and outturn figures and the administration of the devolved taxes?

4. Submissions have been received from John McLaren, Drew Scott, David Ulph and Ken Gibb and these are also attached.

Block Grant Adjustment Mechanism (BGAM)

5. Professor Holtham identifies four options for adjusting the block grant:

- own-base deduction (OBD): the deduction is indexed to the assessed growth of the tax base itself;
- indexed deduction (ID): the initial deduction is indexed to an external variable such as the relevant tax base;

- proportionate deduction (PD): the grant is reduced by a given percentage so the initial reduction grows at the same rate as the grant itself;
- fixed (real) reduction (FD): the grant is reduced by an agreed sum, which may then be indexed to inflation.

6. The UK Government and the Scottish Government have set out their proposed approach to agreeing the mechanism for adjusting the block grant following the introduction of the Scottish Rate of Income Tax (SRIT) and the relevant correspondence is attached. This states that the two governments have agreed to adopt the ID methodology in developing their proposals for the BGAM. This approach to indexing would recalculate the block grant adjustment each year by indexing it to movements in the tax base at a UK level. The UK Government states that:

“The net effect on the Scottish block as a result of adding receipts from the Scottish rate and subtracting the block grant adjustment will therefore depend on the growth in the Scottish rate tax base in Scotland (reflected in the growth in receipts) relative to growth in the Non Savings Non Dividend income tax base in the rest of the UK (reflected in the indexing of the block grant adjustment).”

7. This would mean that “a proportion of funding for Scotland would depend on economic performance.” The Cabinet Secretary for Finance stated in evidence to the Committee on 5 September 2012 that: “the Holtham methodology links the Scottish tax base with the performance of the Scottish economy, which is a welcome and appropriate connection.”¹

8. The two governments have also identified several technical issues to work through including:

- Ensuring that the measure of indexation is based on transparent data;
- The use of forecasts and reconciliation with outturn receipts;
- Ensuring that the adjustment is transparent;
- Selection and preparation of estimates of tax base movements in advance of actual information being available;
- The thresholds and treatment of spill-over effects caused by UK income tax policy decisions;
- The number of annual adjustments.

9. It has also been agreed that the Holtham Method is not appropriate for calculating the block grant adjustment method in respect of Stamp Duty Land Tax and Landfill tax.

¹ <http://www.scottish.parliament.uk/parliamentarybusiness/28862.aspx?r=7438&mode=pdf>

10. Professor Holtham states in his submission that: “Using the UK tax base as the index means domestic policies are not offset but if the UK government alters the tax base it will compensate the effect in the deduction from the block grant.” While he believes that this works well for income tax “it does not work well where there are reasons to think that the UK tax base will grow at a very different rate from that of the devolved territory.” He argues that it “is not in the devolved territory’s interest if its own tax base is inevitably slower growing than that of the UK.”

11. The budget adviser identifies a number of risks for the Scottish government as a consequence of the ID method:

- *Cyclical risk* – the risk should be relatively small;
- *UK policy risk* – the risk to SG revenues is small;
- *Scottish Policy risk* – the SG bears the risk of how its own policies impact on the Scottish income tax base;
- *Asymmetric growth* – this occurs if the Scottish economy grows more rapidly or more slowly than the UK and is intended to encourage growth-enhancing policies.

Jim Johnston
Clerk to the Committee

Principles for distributing and adjusting a block grant around the UK.

The UK has traditionally had a system of *expenditure equalization* among local authorities and that has influenced the block grant to the devolved territories. Revenue support grants for local authorities were not based on equalizing their revenue per inhabitant, as in some other countries. Instead they looked at policy areas for which the local authority was responsible and had formulae to calculate the need for spending in that area given relevant characteristics of the local population, like demographics, poverty etc.

When block grants were introduced for territories following some degree of devolution, expenditures remained the focus. Revenues were not the focus. Instead expenditures in England on those policy areas that were devolved to the territory in question were taken as the basis for the block grant. However, the explicit consideration of need was dropped and instead the same absolute increase on expenditure per head in England was added to the previous year's block grant for the territory – the so-called Barnett formula. The expenditure base was retained but the grant was no longer related to relative need and was fully fungible to the recipient authority. With time any relation to relative need became more remote. The grant is now the largely arbitrary result of a series of historical accidents and ignores changes in relative income, poverty and demographics that have occurred in the devolved territories since the 1970s.

In determining how to proceed in future there are two broad alternatives. Firstly, The UK could decide it is a federation and the origin of tax revenues matters for expenditure. Each territory would have a claim on the tax collected there. There would then, as in most federations, be a series of transfers to equalise the resources per head available in each territory. That would be revenue equalisation that would not attempt to assess relative needs or ensure therefore that public services could be provided to the same standard in each part of the federation. A territory with greater needs, such as a different dependency ratio or greater poverty, would have the same revenue per head as everywhere else with no allowance for those extra needs. That system has simplicity and tractability to recommend it, if little else.

Under such a system Wales and Northern Ireland would be much worse off than they currently are but Scotland might be in a broadly similar position as it currently enjoys, depending on the market price of oil, assuming Scotland gets credit for the revenue from oil production in its geographical sector.

Such a revenue-equalisation system exists in many federations but it would imply necessarily different standards of social services in different parts of the country and the inter-country equalisation system would differ from the intra-country system of revenue support for local authorities if that maintained a system of expenditure equalisation.

The second option would be to attempt to maintain a system of expenditure equalization whereby territorial or regional revenue support was on the same basis as revenue support for local authorities. That means explicit consideration of need would be required given the areas of devolved policy for which the territories are responsible. If we maintain expenditure equalisation, there does not seem to be any alternative to driving the grant off the expenditures of the largest

country, England. Those expenditures could be adjusted for relative need and that would define an expenditure envelop for each territory. Tax devolution requires a further step before a block grant can be calculated. From the expenditure envelop, defined as above, would be subtracted the tax resources of the territory in order to arrive at the block grant. The tax resources would be of two kinds: those tax revenues assigned to the territory and the proceeds of any tax base devolved to the territory, assuming tax rates are levied at the same 'standard' rate as in England. Taxes imposed in the territories that are not levied in England would be ignored as would be any increments or decrements to revenues from having different tax rates from the standard English ones. The principle here is the block grant is calculated assuming a similar tax effort or sacrifice in each territory. If a territory increases or reduces its tax effort either by changing rates or introducing new taxes it takes the proceeds and the block grant is unchanged.

The above arrangement would allow the devolved territory to increase or reduce its tax rates and revenues without prejudicing the block grant. To be sure, there are some complexities involved in valuing the devolved tax base as it moves over time. That valuation is necessary to update the deductions from the expenditure envelop to get the block grant. A design criterion for that valuation is that it should as far as possible leave the consequences of tax policy decisions by the devolved government to fall on the territory but that the consequences of decisions by the UK government should be born centrally. This is a particular issue where a tax base is shared, like income tax under the Scotland Act. The devolved share of the tax base remains susceptible to changes in allowances and thresholds and these remain under UK control.

Treatment of deductions from the block grant can take one of four forms:

own-base deduction (OBD): the deduction is indexed to the assessed growth of the tax base itself;

indexed deduction (ID): the initial deduction is indexed to an external variable such as the relevant UK tax base;

proportionate deduction (PD): the grant is reduced by a given percentage so the initial deduction grows at the same rate as the grant itself;

fixed (real) deduction (FD): the grant is reduced by an agreed sum, which may then be indexed to inflation.

OBD has the disadvantage that it negates the effects that the devolved government's policy may have on a tax base. For example, suppose a devolved government cuts taxes so its revenues initially fall. If reduced taxes result in faster economic growth and growth of the tax base, no net benefit is achieved because the deduction from the block grant will grow with the tax base. Similarly if tax rates are increased and the base shrinks, the deduction will fall, increasing the block grant and buffering the devolved government from the effect of its policy. This system therefore introduces a bias to higher taxes as well as violating the design criteria. It offsets domestic policies while leaving the tax base vulnerable to actions by the UK government in the case of a shared base.

ID counteracts these disadvantages if a reasonable index is to hand. Using the UK tax base as the index means domestic policies are not offset but if the UK government alters the tax base it will compensate the effect in the deduction from the block grant. In my opinion this works well for

income tax. However it does not work well where there are reasons to think the UK tax base will grow at a very different rate from that of the devolved territory.

PD may be reasonable but leaves a shared tax base exposed to changes of policy in the UK and any compensation has to be negotiated ad hoc.

FD is the simplest. If governments can agree a present value of expected future tax receipts that can be subtracted from the block grant in a one-time adjustment. That would work for a slow-growing or static tax base. Where the tax base grows with the economy there may still be a real annuity equivalent, i.e. there is an initial deduction that is then indexed to inflation. The UK Treasury may well be reluctant to agree to this for taxes whose base is growing strongly or may demand a very large initial deduction.

The various approaches are discussed in detail in the report of the Independent Commission on Funding and Finance for Wales (ICFFW) 'Fairness and Accountability' of July 2010. Note especially chapter 5 and Annexes 7 and 8¹.

The UK Treasury initially accepted PD, as recommended by the Calman Commission but subsequently agreed to the ID approach for income tax. Having initially argued that ID was 'too complicated' it has more recently wished to apply it across the board. This is not in the devolved territory's interest if its own tax base is inevitably slower growing than that of the UK. In discussions over corporation tax in the Northern Irish case, the Treasury has also argued for increasing the deduction for losses to the UK tax base from lower taxes in Northern Ireland. That is inappropriate in my view. If one spill-over is considered, all calculable spill-overs should be taken into account. Alternative solutions to questions of spill-over are available such as allocating company tax liability better and limiting tax differentials.

It remains to discuss the determination of relative need if expenditure envelopes are to account for differences in need. In practice needs formulae used in local government and health are generally very complicated recognizing a large number of different factors. That is explicable because they are determined in a political process where the concerns of different groups can be shown to be met if an appropriate variable is included in the formula. However, from a practical viewpoint many of the variables are redundant in fixing the size of revenue support because they are highly correlated with each other. They tend to reflect a few underlying factors. Those are: *dependency*, that is the proportion of old people and children in the population; *poverty*, the proportion of poor people; *sickness*, the proportion of the population with chronic illness; and cost. The biggest determinant of relative cost of providing services, at least outside London, is *sparsity*; it is more expensive to provide services to a scattered population.

The ICFFW² report found over 95 per cent of the variation in revenue support grants to local authorities in Great Britain and in grants to area health boards could be explained by an equation of some half a dozen variables representing those four factors. A needs adjustment that allowed for those factors in determining relative expenditure per head would therefore be an enormous improvement on making no needs adjustment while more refined or complicated efforts to identify relative need would be more expensive and more open to political challenge over detail. In my opinion a coarse adjustment should be easy to do and to justify relative to the option of not doing it. An attempt at refined adjustment could get bogged down in interminable normative disputes.

Of course even when we have secured agreement on the few basic factors that are relevant to a needs adjustment, there is considerable scope for disagreement over how much weight to attribute to each factor. The Independent Commission's report simply ran a cross-section regression and obtained parameters from current practice. In other words it claimed to have identified the 'revealed preference' of current governments. That is not, of course the last word. When the results are scrutinized governments may decide that the results are not what they meant and there will be different preferences among the devolved governments of the UK and Westminster. Nonetheless the existing dispensation and its summary representation seems a reasonable starting point for discussion.

The evidence suggests that an approach of this kind would leave Wales and Northern Ireland in a situation not massively different from their current one. It would, however, tend to reduce the resources going to Scotland. To see that it is sufficient to note that Wales scores worse than Scotland on almost all the need factors listed above yet grant-financed expenditure per head in Scotland is considerably higher than in Wales.

It might be necessary to add a clarification here. When we talk of an expenditure envelop, driven off English expenditures, we are talking of a way of determining a block grant. The idea being that it is necessary to take account of relative need if we are to assure the same level of public services in different parts of the country but it is unreasonable to go beyond that and to expect English tax payers to pay for better public services in other parts of the union than they are prepared to finance for themselves. However, devolution means that the devolved territory is not confined within that envelop; it can have better (or worse) public services if it chooses to raise (or lower) taxes. In either case it will not be penalised by changes to the block grant. That seems to me to be the best achievable situation in the context of a continuing union.

Gerald Holtham

15th April 2013

¹ The report can be viewed on the Welsh government website:
<http://wales.gov.uk/funding/financereform/report/?lang=en>

² See chapter 3 and Annex 4

The Block Grant Adjustment

David Bell

University of Stirling

April 2013

Introduction

This paper discusses the Block Grant Adjustment (BGA). This is the method by which the block grant to the Scottish Government (SG) will be adjusted after the implementation of the tax provisions in the Scotland Act 2012. The block grant is the annual allocation to the Scottish Government made by the UK government. It covers both capital and resource spending and enables the Scottish Government to fund its spending programmes across health, local government, transport, education etc. It is largely determined by the Barnett Formula.

The tax powers in the Scotland Acts are intended to make the Scottish Parliament more accountable for the spending decisions it takes. SG (and Scottish local government) currently control around 70% of public spending in Scotland. The intention of the Act is to change the share of tax revenue raised in Scotland from around 15% of the SG budget to approximately 35%. This increase will be achieved through the new taxation powers contained in the Scotland Act 2012.

These are:

- The Scottish rate of income tax (SRIT), which will replace part of UK income tax.
- The Scottish land tax.
- The Scottish landfill tax

To offset the additional revenue from these taxes, there has to be a reduction in the block grant paid by the UK Government to SG. How the Block Grant Adjustment (BGA) will be calculated is the subject matter of this paper. Although a somewhat arcane topic, the design of the BGA will be critical for the spending plans of SG. It is also important to bear in mind that a larger BGA means a smaller block grant will be paid by UK government to SG.

There will be a transition period before the full implementation of these new taxes, so that the necessary administrative mechanisms can be put in place. This means that there is also some time during which to agree the structure of the BGA. During the transition, which has already started, the Barnett formula will continue to determine the SG level of funding.

The main elements of the transition are:

April 2012: Forecast of Scottish tax receipts and assignments of tax revenues to the Scottish Parliament

April 2013: new borrowing powers for capital expenditure.

April 2015: devolution of Stamp duty land tax and landfill tax

April 2016: new Scottish rate of income tax with transitional arrangements

After 2016: Once there is "clear evidence that the new forecasting and collection systems are operating correctly, transitional arrangements will cease¹"

After the transitional period ends, the Treasury will reduce the block grant that will correspond to the revenue raised by the new income tax power. This will be based on outturn data on tax receipts from the Survey of Personal Incomes and the forecasts made by the Office of Budget Responsibility (OBR)." HM Government also realises the importance of this mechanism. It has argued that "the

¹ HM Government (2010) "Strengthening Scotland's Future"

policy decision on which methodology to use for this calculation is fundamental to the future success of the new financing arrangements and will be taken in consultation with the Scottish Government". Thus both governments acknowledge the importance of the BGA to the successful implementation of the Scotland Act 2012. Four possible mechanisms were initially proposed. These were: own base deduction (OBD), indexed deduction (ID), proportionate reduction (PD) and fixed real deduction (FRG)². The decision has been made to use the ID method whereby an "offset" is calculated for an initial year, which should be equal to the value of Scotland's tax receipts in that year, so that the total revenue accruing to SG is not affected. In subsequent years, under the ID method, the offset is indexed to some external point of reference, such as the growth in comparable UK tax receipts. What resultant risks will the Scottish government face?

- **Cyclical risk.** This kind of risk is associated with changes in the business cycle (booms and recessions) that affect Scotland and rUK equally. Under the ID method cyclical risks should be relatively small. Suppose there is a recession that equally affects Scotland and the UK as a whole. This will have a negative effect on tax receipts on both sides of the border. The growth of comparable tax receipts in rUK will decline. This reduce the size of the offset (thus increasing the size of the block grant) which will compensate for the effect of the recession in reducing Scotland's own income tax receipts.
- **UK policy risk.** Suppose that the UK government changes allowances on income tax, reducing its yield in Scotland and the UK. The risk to SG revenues is small since indexation of the offset to the UK income tax base means that the offset will be reduced if the RUK income tax base contracts. There are possible exceptions to this effect that are discussed in more detail subsequently.
- **Scottish policy risk.** If the Scottish Government embarks on a policy which harms the Scottish income tax base, then it will incur the costs of so doing since the BGA will not be adjusted to compensate the Scottish budget.
- **Asymmetric growth.** This occurs if the Scottish economy grows more rapidly or more slowly than the UK. Suppose there is a more severe recession in Scotland. Indexation of the offset to the UK tax base means that Scotland has a revenue shortfall – the BGA is growing more rapidly than tax revenues. This is part of the rationale for the introduction of SRIT – to encourage SG to genuinely promote growth-enhancing policies.

The principles agreed by the Joint Exchequer Committee to underpin the BGA mechanism are listed in Annex 1. These have been arranged in a generally amicable way that is intended to produce "no detriment" to either party. However, one cannot be certain of the longevity of this amity, and once rules are agreed, they tend to be difficult to revoke.

We now consider the BGA in some greater detail. It has two components. First, there is the adjustment for SRIT. Second there is the smaller adjustment that has to be made in relation to the other taxes. In relation to SRIT, there is agreement that indexation should be based on

² These are discussed in my previous paper "The Scottish Budget Process and the Scotland Act 2012" http://www.scottish.parliament.uk/S4_FinanceCommittee/Reports/Budget_Adviser_paper_on_budget_process.pdf

“comparable” adjustment to the UK income tax base. But what does “comparable” adjustment mean? Suppose an increase in UK income tax revenues was concentrated among high earners, Scotland’s SRIT receipts would not increase at the same rate as those in the UK as a whole because it disproportionately draws its revenues from the lower end of the income scale. This is because SRIT, which will initially be calculated on the basis of being levied at a rate of 10p in the pound accounts for one half of the 20p basic income tax rate, one quarter of the 40p higher rate and only two ninths of the 45p additional rate.

Therefore, if the BGA was indexed to the overall increase in UK income tax receipts, it would increase more quickly than SRIT receipts, leaving the SG with a reduced budget. This outcome is purely the result of the structure of SRIT. It is not necessarily due to the relatively poor performance of the Scottish economy. The calculations of how SRIT revenues are generated are complex, but can perhaps be clarified by example. Table 1 shows how much tax is generated by the Scottish rate at different levels of gross income, given current income tax rates and allowances (assuming a person of working age with no allowances other than the personal allowance) and assuming that SRIT is initially set at 10p.

Individuals with incomes below £9440 (the current personal allowance) will not pay any income tax to either the UK Government or SG. A slightly higher income of £10,000 generates a small SRIT liability of £56. Then for each additional £1000 of income, SRIT liability increases by £100. This continues until income reaches £100,000 after which the personal allowance is removed. The share of income accounted for by SRIT liability then reaches 10 per cent, having increased from 0 per cent for all incomes less than £9,440.

Table 1: Income Tax Payable to Scottish Government at Different Levels of Income

Gross Income	£10,000	£20,000	£40,000	£100,000	£200,000
SRIT	£56	£1,056	£3,056	£10,000	£20,000
SRIT as a share of income	0.6%	5.3%	7.6%	10.0%	10.0%

This relationship is also shown in Figure 1 along with the liabilities accruing to HMRC. Whereas SRIT operates almost like a “flat tax” – accounting for almost a fixed share of income across a wide range of gross incomes, the progressivity of income tax rates means that HMRC takes a much larger share of the incomes of high earners in Scotland than does SRIT.

Figure 2 addresses a slightly different issue. Suppose that Scottish Enterprise was able to attract a number of new workers to Scotland. The number of workers may vary, but they jointly earn £1m. Given the structure of SRIT, what number of workers (and level of income) would generate the highest SRIT revenues for the Scottish Government? Would it be best to have 100 earning £10,000 each, 20 earning £50,000 or perhaps just a single millionaire? Figure 2 shows how SRIT revenue changes as the number of workers changes. It also shows how the revenues accruing to HMRC vary.

Scottish Government revenue increases as the number of workers falls, but not by nearly as much as that accruing to HMRC. For HMRC, it is best to have one person earning £1m which means that it

does not have to offer any personal allowance and maximizes the amount of income taxed at the additional rate. In Scotland, it is generally better to have fewer workers. For example, if there were 200 earning £5,000 there would be no SRIT generated, since each worker would be earning less than the personal allowance. However, once there are ten or fewer workers earning £100,000 or more, total SRIT revenue is fixed at £100,000 and does not increase. The reason for this is that once the income limit for personal allowance (£100,000) is exceeded, all income is being taxed at 10p in the pound, irrespective of the number of workers. Therefore whether it is 10 workers earning £100,000 or one person earning £1m, the joint tax liability for SRIT will always be £100,000 – 10 per cent of total income. This contrasts with the incentive for HMRC to have as few workers as possible to maximise the income taxable at the higher and additional rates.

Figure 1: SRIT Receipts by Level of Gross Income

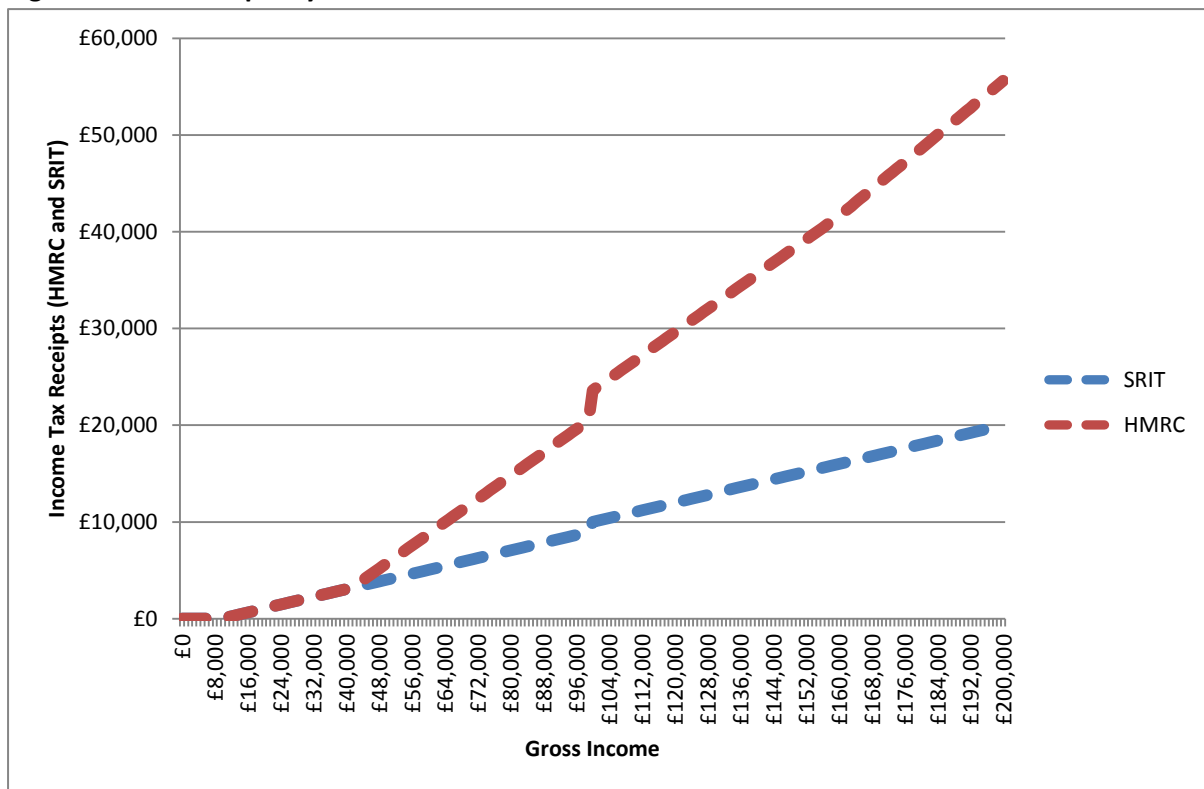
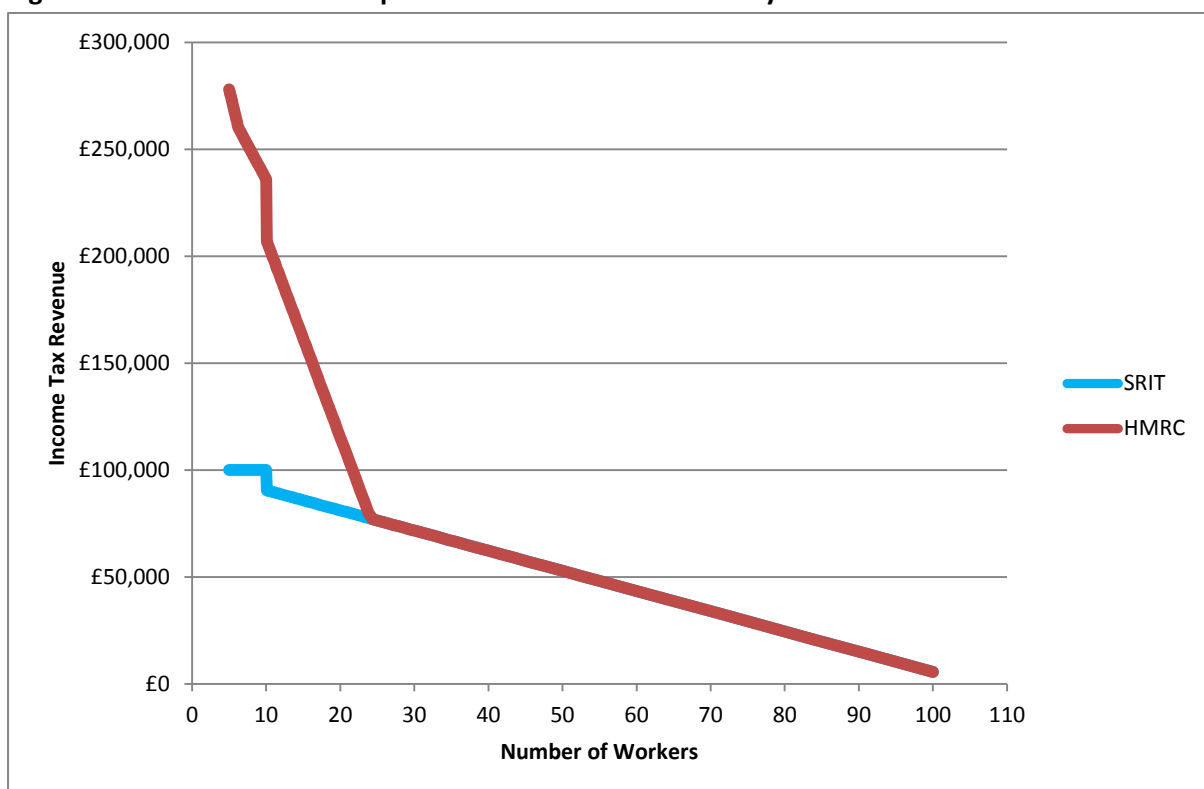


Figure 2: SRIT and HMRC Receipts when £1m income earned by different numbers of workers



What does this imply for BGA? Clearly it suggests that the structure of SRIT is less dependent on high income earners than is the case for overall UK income tax. SRIT revenues are not enhanced to the

same degree as those of HMRC by equivalent growth in the number of higher rate and additional rate taxpayers. Thus, in assessing the BGA in respect of SRIT, the appropriate indexation method is not to adjust it by the overall increase in income tax revenues in rUK.

Detailed data on liabilities by tax band are not currently available from the OBR, though the White Paper “Strengthening Scotland’s Future” states that: “Adjustments to the block grant to reflect changes to the income tax structure will be obtained from the OBR. The OBR will estimate the financial impact (either cost or benefit) to UK Exchequer of any changes to the tax system at the annual budget and other fiscal events.”³

Clearly it is essential that the BGA calculations are carried out on a “like-for-like” basis. This is not an easy calculation. Some details are sketched out in Annex 3. A number of conclusions do follow from the analysis, based on the assumption that the BGA calculations are carried out on a comparable basis in the sense of mimicking the ways in which SRIT will generate revenue for the Scottish Government. These conclusions are:

1. Other things being equal, an increase in employment in Scotland relative to rUK of either basic rate or higher rate taxpayers would increase SRIT revenue more than BGA. Hence SG revenues would be increased
2. Other things being equal, an increase in average wages in Scotland relative to rUK of either basic rate or higher rate taxpayers would increase SRIT revenue more than BGA. Hence SG revenues would be increased
3. Not only do average wages matter, so too does their distribution. It is possible that an increase in the personal allowance would take more Scottish taxpayers out of income tax than in rUK, which might have an adverse effect on SG revenues.
4. Similar considerations do not apply to the higher rate threshold, since the Scottish taxpayer contributes 10 per cent to SRIT, whether above or below this threshold.
5. An increase in tax revenue in rUK based solely on increased higher rate payments should receive only one quarter of the weight that it would be given in a calculation of the overall increase in the value of rUK income tax receipts. This is because SG will only receive 25 per cent of the value should a similar increase focussed on higher rate taxpayers occur in Scotland.

Smaller Taxes

Arrangements for the BGA in respect of the smaller taxes were also set out in the White Paper. Key paragraphs are set out below:

“When the smaller taxes are devolved, currently planned to be April 2015, there will be a one-off reduction which will then be deducted from the block grant for all future years.”

³ HM Government. (2010) "Strengthening Scotland's Future", P. 36

“Upon the passage of the Scotland Bill, the UK Government will engage with both the Scottish Government and Parliament on the means of calculating the reduction in block grant associated with the devolution of SDLT and LfT.”

“In contrast to income tax, which will in future apply to a tax base shared between the Scottish and UK Parliaments, these taxes will be completely devolved to the Scottish Parliament and hence any changes to the rates or structure of a tax by one jurisdiction will not have a direct impact on the receipts of the other. Hence there will be no need for subsequent adjustments to the block grant to compensate for changes to these taxes after their devolution.”

Mr Swinney has made it clear to Mr Chisholm that the concerning these negotiations have not yet been completed⁴. And that part of the negotiation reflected a desire on the part of the Scottish government to remove the volatility of tax receipts, particularly in SDLT, through a five-year averaging procedure. The question of what exactly constitutes a “one-off reduction” is also open. The White Paper does not make it clear whether this reduction will be fixed in nominal or in real terms. In the next section, a putative “Scotland Act” budget is constructed and it is assumed that these smaller taxes are indexed on using the GDP deflator. However, given the particular nature of these smaller taxes, there is no compelling case for the use of one deflator rather than another. For example, one might argue that the correct deflator for SDLT should reflect changes in the property costs, which are not closely related to GDP. However, this begs the question of what is the appropriate property index, given that these are likely to differ between Scotland and rUK.

Constructing a Scotland Act Budget

Following from the previous section, therefore, Table 2 illustrates how a future “Scotland Act” budget might be constructed, taking account of what is already known about BGA and making some assumptions about the final agreement over its structure. The illustrative calculations are for 2012-13 to 2014-15, well before the financial provisions of the Scotland Act 2012 are to be implemented. The table has line numbers for ease of reference.

The basis for Table 2 is the OBR forecast of Scottish tax revenues issued along with the March 2013 UK budget. Thus, lines 1-5 give actual and forecast UK tax receipts for income tax, stamp duty land tax, landfill tax and the aggregates levy for the period 2012-13 to 2017-18 (from 2011-12 in the case of income tax). From 2012-13 to 2017-18 income tax revenues are expected to increase by 31%, stamp duty land tax by 69%, landfill tax by 9% and the aggregates levy by 19%.

⁴ See Annex 2

Table 2: March 2013 OBR forecasts for Scottish taxes and example estimates of BGA

Line	£ million	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
	Forecast UK Tax Receipts:							
1	Income Tax	142700	140900	147500	152000	162400	173400	185200
2	Stamp Duty Land Tax		6941	7748	8366	9325	10450	11738
3	Landfill tax		1084	1040	1139	1150	1153	1186
4	Aggregates Levy		268	273	284	293	305	319
5	All comparable taxes		149193	156561	161789	173168	185308	198443
	Forecast Scottish Tax Receipts:							
6	Scottish Rate of Income Tax	4330	4240	4246	4332	4649	4976	5308
7	Stamp Duty Land Tax	275	323	348	372	410	456	509
8	Landfill tax	98	99	95	104	105	105	108
9	Aggregates Levy	52	49	48	49	51	53	56
10	All comparable taxes	4755	4711	4737	4857	5215	5590	5981
	Scottish Share of:							
11	Income Tax		3.01%	2.88%	2.85%	2.86%	2.87%	2.87%
12	Stamp Duty Land Tax		6.70%	6.30%	6.09%	5.92%	5.80%	5.71%
13	Landfill tax		9.13%	9.13%	9.13%	9.13%	9.11%	9.11%
14	All comparable taxes		3.18%	3.04%	3.02%	3.03%	3.04%	3.03%
	Growth in:							
15	UK Income Tax Receipts			4.68%	3.05%	6.84%	6.77%	6.81%
16	UK Stamp Duty Land Tax			11.63%	7.98%	11.46%	12.06%	12.33%
17	UK Landfill tax			-4.06%	9.52%	0.97%	0.26%	2.86%
18	UK Aggregates Levy			1.87%	4.03%	3.17%	4.10%	4.59%
19	All comparable UK taxes			4.94%	3.34%	7.03%	7.01%	7.09%
20	GDP Deflator	2.10%	1.30%	2.30%	1.90%	1.80%	1.70%	1.70%
21	2013-14 Scottish Budget (£m) Cash	29107	28603	27748	27281			
	Offsets Indexed to UK taxes & GDP Deflator							
22	Income Tax		4240	4439	4574			
23	Stamp Duty Land Tax		323	330	337			
24	Landfill tax		99	101	103			
25	Aggregates Levy		49	50	51			
26	Total Offset		4711	4920	5065			
	Example 1							
27	Scotland Act 2012 Scottish Budget		28603	27565	27073			
28	Difference Scotland Act Budget -		0	-183	-208			

	2013-14 Scottish Budget			
	Example 2			
29	Alternative offset (2% growth in comparable income tax)	4711	4807	4902
30	Scotland Act 2012 Scottish Budget	28603	27678	27236
31	Difference Scotland Act Budget - 2013-14 Scottish Budget	0	-70	-45

Lines 6-10 give corresponding Scottish estimates for the same taxes. Thus, revenue from SRIT is expected to increase from £4,240 million to £5,308 million between 2012-13 and 2017-18. Its forecast growth is 25% between 2012-13 and 2017-18. The slower rate of growth in SRIT compared with the overall UK income tax receipts reflects the greater dependence of SRIT on the lower bands of income tax, where receipts grow more slowly than in the higher bands. Revenue from stamp duty land tax also grows more slowly, probably due to the lower valuation of domestic and commercial property in Scotland. Landfill tax grows relatively slowly in both jurisdictions due to increasing charges for landfill disposal. Finally, the aggregates levy also grows relatively slowly, by 14% in Scotland between 2012-13 and 2017-18. This tax generates very small revenues, particularly in relation to SRIT.

Lines 11-14 show the Scottish share of the comparable taxes. This share of income tax is much lower than Scotland's population share because it also reflects the limited proportion of total income tax generated in Scotland which will be allocated to SG. This share of stamp duty land tax is also less than Scotland's population share, but this again reflects lower property values in Scotland. In contrast, the share of landfill tax is relatively high in Scotland, because landfill is a more common method of disposal than in the rest of the UK. Line 14 shows that the revenues allocated to Scotland make up just over 3% of aggregate UK revenue on the comparable taxes. This is almost exclusively driven by the SRIT calculation.

Lines 15-20 shows forecast growth rates of comparable UK taxes. It is based on the OBR assessment of the U.K.'s economic prospects. For SRIT the relevant growth rate is that associated with UK income tax receipts. However, this may be somewhat misleading in that it measures the growth rate of *all* income tax receipts, not those weighted to the comparable tax bands as described above. If the overall UK growth rate is applied to the BGA and the increase in income tax receipts is concentrated in the upper and additional rate bands, then the increase in the BGA will exceed the additional revenue generated by SRIT, leading to a reduction in the resources available to SG. Table 1 gives an example of this effect. It assumes that the Scotland Act was implemented in 2012-13. Line 2 shows the cash budget available to SG for the period 2011-12 to 2014-15. The values are drawn from the 2013-14 Scottish Draft Budget, which in turn reflects the 2010 Spending Review. These totals are derived by application of the Barnett Formula to departmental budget allocations. These will continue to be calculated after the implementation of the Scotland Act, since, without an estimated block grant, the BGA is meaningless. This will mean that once the data on tax revenues become available, it will be possible to identify very clearly whether SG would have a larger budget with or without the tax powers granted under the Scotland Act. This will perhaps become a key

statistic on which to judge the success or otherwise of SG economic strategy and will certainly be of interest to the Finance Committee.

Lines 22 to 25 for 2012-13 reproduce the OBR forecast of Scottish tax revenues in that year. Total forecast revenue is £4,711 million. In the first year, the intention is to ensure that the Scottish budget is unaffected by the introduction of additional tax powers. Hence, the size of the BGA is £4,711 million. This comprises a £4,240 million offset in respect of SRIT and a “once and for all” adjustment for the other taxes of £471 million. Thus, the difference between the original 2012-13 Scottish budget and the “Scotland Act” budget for 2012-13 is zero. In 2013-14, the need to ensure that these totals are equal is dropped, so SG can gain or lose relative to the Barnett-based budget.

Lines 22 to 26 for 2013-14 and 2014-15 illustrate how such a calculation might be made. In respect of income tax, for example, the “indexation” that is used is the rate of growth of UK income tax receipts. Thus applying a 4.68% increase to the 2012-13 forecast Scottish income tax receipts gives a figure of £4,439 million. For the smaller taxes, after the “one-off” settlement in 2012-13, it is assumed that the value of this settlement will remain constant in real terms. This is achieved by applying the 2013-14 GDP deflator to the 2012-13 value of each of the smaller taxes. When added together, these offsets imply a BGA in 2013-14 of £4,920 million and £5,065 million in 2014-15. These offsets are larger than the forecast tax revenue for Scotland in these years and as a result, the “Scotland Act” budget is lower than it would have been under the Barnett formula. The difference in 2013-14 is £183 million and in 2014-15 is £208 million. Why has this come about? Firstly, the expected increase in income tax receipts in Scotland is perhaps too high, due to the application of the *overall* increase in income tax receipts at the UK level, rather than the increase in the *comparable* parts of income tax receipts as discussed above. Second, one might argue that given the particular characteristics of the smaller taxes, the GDP deflator is not appropriate. For example, one might expect that the landfill tax will continue to diminish rather than increase in real terms as the unit costs of landfill are increased.

Lines 29 to 31 describe a different example where the increase in *comparable* income tax has been set to 2%, which is perhaps more realistic. The consequence of this is that the BGA declines, so that the difference between the Barnett-determined budget and the “Scotland Act” budget also falls to £70 million in 2013-14 and to £45 million in 2014-15.

The size of the BGA will be larger, if there are UK economy experiences changes that particularly increase receipts at the basic rate of income tax. An increase in UK immigration, leading to higher employment would generate such a change. If the Scottish economy does not achieve a similar increase in immigration, its budget will fall relative to that measured under the Barnett formula.

Note that the Scotland Act does not insulate the SG budget from deficit-reduction measures. The BGA is applied after the Barnett-determined budget has been set. This budget may well be cut after the forthcoming spending review. Neither would it necessarily have an effect if the UK adopted needs-based funding for Scotland, Wales and Northern Ireland, though it is likely that SG would seek to renegotiate the terms under which it is calculated if this were to occur.

The BGA is clearly a complex, though vital, component of the Scotland Act. Its final form is not yet agreed. It appears that the key issue likely to cause variation in the revenue available to the Scottish Government under the Scotland Act and that from the current formula is the relative growth of employment and earnings in Scotland and rUK. One difficulty may be changes in the personal allowance, which may lead to differential effects on SRIT growth and growth in “comparable” revenues in rUK.

ANNEX 1: Principles agreed between UK and Scottish governments at the Joint Exchequer Committee relating to the Block Grant Adjustment⁵

Design

1. Apply the overarching objective of fairness to both the UK and Scottish Governments by:
 - a) limiting the risk of an unintended transfer of resources one way or the other;
 - b) ensuring that the mechanism is not, when implemented, designed to gain advantage in one set of fiscal circumstances or another;
 - c) considering the effects of a shared tax base (including issues related to policy spillover and tax avoidance).
2. Ensure the mechanism delivers on the Scotland Bill's aims to increase financial accountability and gives the Scottish Parliament a direct financial stake in Scotland's economic success;
3. Ensure the mechanism is consistent with Azores criteria and State Aid principles;
4. Ensure the sustainability of the system to adapt to future decisions on tax devolution;

Implementation

5. Ensure that, when the system is introduced it does not cause an unmanageable change in the Scottish budget (up or down) in the first year;
6. Ensure that the necessary information and data is shared on a timely and accurate basis to allow both the UK and SG to plan ahead;
7. Ensure the mechanism delivers value for money by designing a model that is relatively simple to implement and operate and incurs minimal administrative cost;

Review

8. Apply principles of transparency; and
9. Review to ensure that the system remains fair and 'fit for purpose'.

⁵ See: http://www.scottish.parliament.uk/S4_PublicAuditCommittee/Meeting%20Papers/Joint_Exchequer.pdf

ANNEX 2: interchange between Mr Swinney and Mr Chisholm in relation to BGA for SDL T⁶

John Swinney: That will be a material test, Mr Chisholm—I think that that is the best way to describe it. There are a number of points here that are fundamental to the issue. Mr Chisholm is absolutely correct in that, historically, there has been quite significant volatility. For example, in 2007-08, total Scottish receipts of SDLT were £565 million. These figures are not estimates; they are HMRC data on tax collected. I will give the series of numbers for the record: the tax collected was £565 million in 2007-08; it went down to £320 million in 2008-09 and £250 million in 2009-10; it went up to £330 million in 2010-11; and it went down to £275 million in 2011-12. The highest figure was £565 million and the lowest was £250 million, which shows a significant amount of volatility.

The fair and reliable way of considering the issue is to take an average of those five years and make an adjustment on that basis. The command paper for the Scotland Act 2012 assumed that a one-off change to the block grant adjustment would be made, and the Scotland Bill Committee in the previous Parliament stated that it should be a one-off, non-index-linked adjustment to the block grant. I think that we must take into account the average for that five-year period.

The point that you make about the OBR is a material issue for the committee to consider. The OBR has undertaken two forecasts—one in March 2012 and the other in December 2012—and I expect that we will get another one in the March budget on 20 March. Between the March and December forecasts in 2012 that looked forward from 2012-13 onwards, the OBR reduced the estimated tax-take by 9.75 per cent, 11.1 per cent, 13.6 per cent, 13.3 per cent and 13.4 per cent. I put those numbers on the record to make the point that, given that pattern, the forward estimating of SDLT is very difficult. I therefore think that a retrospective average assessment is a much more reliable way of making the block grant adjustment. Obviously, that is a subject of discussion with the UK Government.

Malcolm Chisholm: So there has been no agreement on that.

John Swinney: There is no agreement on it. I have made the point to the UK Government that I expect to receive the budget numbers for our 2015-16 budget sometime in the next six months and, because this matter will be material to our 2015-16 budget, I presume that those will be net of stamp duty land tax, so we have to reach an agreement about this in relatively short order.

⁶ Scottish Parliament Finance Committee Meeting 27th of February 2013
<http://www.scottish.parliament.uk/parliamentarybusiness/28862.aspx?r=7778&mode=pdf>

ANNEX 3: Calculating the BGA

Suppose that, in respect of SRIT, BGA is determined according to the rule:

$$BGA_t = BGA_{t-1} * \frac{\hat{T}_t^{rUK}}{T_{t-1}^{rUK}}$$

which means that the forecast BGA for period t is the same as that for period $t-1$, *multiplied* by the rate of increase in *total* income tax receipts in rUK between period $t-1$ and period t . The caret symbol “^” indicates that the tax revenues for period t are *forecasts* made by the OBR. However, if the increase in tax revenues between period t and period $t-1$ involves *any* payments relating to higher or additional rate income tax, the BGA will grow faster than SRIT revenue, since the revenue accruing to SRIT is less than 50 per cent in these income tax bands.

The correct calculation are as follows⁷. First break down any change in employment between period $t-1$ and period t into employees earning more than the personal allowance, N_t^{BR} and less than the upper rate threshold (basic rate taxpayers) and those earning above the higher rate threshold, (currently £41,450 = £9440 personal allowance, PA_t , plus £32,010 income payable at the basic rate) (higher rate taxpayers). Note that change in the number of workers earning less than the personal allowance has no effect on the SRIT calculations since they pay no income tax. Denote the average wage earned by these two groups as \bar{w}_t^{BR} and \bar{w}_t^{UR} . Further denote by BR_t the value of total basic rate payments made by those whose income exceeds the higher rate threshold, HT_t . They have to pay tax on the entire basic rate band and the total cost of so doing is currently £6402. Then the overall change in “comparable” revenues (evaluated at the assumed rate of 10p in the pound) between period $t-1$ and period t is given by:

$$\begin{aligned} T_t - T_{t-1} &= 0.5 * 0.2 * \left((\bar{w}_t^{BR} - PA_t) N_t^{BR} - (\bar{w}_t^{BR} - PA_{t-1}) N_{t-1}^{BR} \right) \\ &\quad + 0.25 * 0.4 * \left((BR_t + \bar{w}_t^{UR} - HT_t) N_t^{UR} - (BR_{t-1} + \bar{w}_{t-1}^{UR} - HT_{t-1}) N_{t-1}^{UR} \right) \\ \Delta T_t &= 0.5 * 0.2 * \Delta \left((\bar{w}_t^{BR} - PA_t) N_t^{BR} \right) + 0.25 * 0.4 * \Delta \left((BR_t + \bar{w}_t^{UR} - HT_t) N_t^{UR} \right) \end{aligned}$$

where Δ indicates a change from period $t-1$ to period t . Applying this calculation to rUK will give an estimate of the rUK equivalent of SRIT, which in turn can be used as a basis for calculating the BGA. Though this is a complex formula, it exposes a number of important considerations relevant to both SRIT and the BGA. These include:

6. Other things being equal, an increase in employment in Scotland relative to rUK of either basic rate or higher rate taxpayers would increase SRIT revenue more than BGA. Hence SG revenues would be increased
7. Other things being equal, an increase in average wages in Scotland relative to rUK of either basic rate or higher rate taxpayers would increase SRIT revenue more than BGA. Hence SG revenues would be increased

⁷ Note that we ignore the additional rate and the limit on personal allowances in this calculation, partly to avoid further complication and partly because they do not generate much SRIT revenue.

8. Not only do average wages matter, so too does their distribution. If a greater proportion of Scottish workers are removed from paying income tax due to an increase in the UK-wide personal allowance, SG revenues might be adversely affected.
9. Similar considerations do not apply to the higher rate threshold, since the Scottish taxpayer contributes 10 per cent to SRIT, whether above or below this threshold.
10. An increase in tax revenue in rUK based solely on increased higher rate payments should receive only one quarter of the weight that it would be given in a calculation of the overall increase in the value of income tax receipts. This is because SG would only receive 25 per cent of the value of a similar increase occurring in Scotland.

Issues of interest with regards to the economic and financial implications of the Scotland Act

1. What impact might there be on economic growth and what would be the causal path?

(Much of the following is made with reference to a paper by CPPR that is expected to be published early next week. I will supply all roundtable participants with the full paper in advance of our meeting.)

One argument put forward for increased powers is that it would both improve the economic growth rate and narrow a perceived gap between Scotland's growth rate and the higher growth rates experienced by other countries, including the UK.

Comparative analysis of UK vs Scottish growth rates show that, depending on how growth is measured, Scotland can be seen as growing faster or slower. So, for example:

Excluding North Sea activity

- In real (ie inflation adjusted) terms, Scotland grows more slowly than the UK over the period 2001-2011. However, in cash terms Scotland grows faster than the UK over the same period.
- Adjusting for Scotland's slower population growth, in order to get GDP growth per capita, eradicates the real terms UK advantage and increases the cash terms annual growth advantage.

Including North Sea activity

- In real (inflation adjusted) terms, an independent Scotland would have exhibited negative growth over the period 2001-2011, well below that seen for the UK. (Note: if an independent Scotland retained the official measure of growth currently used by both the Scottish and UK government's these would be the published headline growth figures.)
- In contrast, in cash terms, Scotland grows significantly faster than the UK.
- The reason for these contrasting results is the effect that North Sea oil & gas has on the figures. Falling oil production reduces real terms GDP output, but as oil prices have been rising by even more, the cash value of overall GDP output has been rising faster than is seen for mainland GDP. This effect applies to both Scotland and the UK. However, since the North Sea makes, proportionally, a much bigger contribution to Scottish than UK GDP, the impact on Scotland is magnified, improving its cash based performance but worsening its real terms performance.

These comparative growth rates highlight the need for greater precision over what is the gap that is expected to be closed by greater fiscal powers.

In truth, Scotland consists of two separate economies, an onshore one, which is affected by a variety of government policies, and an offshore one, over which Scotland/UK government has little control other than through taxation powers.

As a result, greater clarity is needed over what is the most appropriate growth rate to measure and how it compares with other countries

There is also a question mark hanging over how high a rate of future economic growth we might expect.

Recent analysis by CPPR highlights the slowing of growth over recent decades for most countries (see Table 1). This brings into question whether achieving any 'normal' rate of growth in the future is still relevant.

As a result the new powers are being introduced against a highly uncertain background with regards to:

- (i) any relative Scottish under/over economic performance, and
- (ii) what a 'good' rate of long term economic growth would be in the future.

If a higher Scottish growth rate is to be achieved what is the impact of the various incentives and disincentives for growth that will have been introduced? Is there an ability to use devolved tax revenues to affect policies, which would in turn boost future tax revenues, in particular by a shift in the level of the income tax rate vs the UK? It will be a very difficult task to evaluate this, in terms of separating out any effect from the Scotland Act with other possible causes of under/over performance.

If change does occur will it be best achieved through the greater personal incentives of a lower tax rate or via the impact from what any higher tax revenues are spent on? What would be the difference between spending any such higher taxes on higher benefits vs more infrastructure for example.

If such a devolution of powers makes sense at the Scottish Government level then there must be a strong argument that it makes sense at the Local Government level and possibly at other levels in order to promote faster growth? What evidence exists over the level at which the benefits of greater devolved fiscal powers applies?

With regards to each of the issues above the Finance Committee (and others) have a potentially important role to play in making sure that evaluation of success in each area is both possible and is actually carried out. In order to do so we need to: collect data; analyse data; have a robust baseline to measure change from.

2. What is the reliability of Scotland's share of UK income tax revenues that OBR will be forecasting?

Previous GERS have highlighted that Scotland's share is not only low, relative to its population, but has been shifting over time. This has proved difficult to explain and could potentially affect the 'correct' level of revenues coming to Scotland and how these change year by year.

For example, between 1995-96 and 1997-98 this share stood at around 8% of the UK total, whereas by 2000-01 it had fallen to 7%. More recently it has been more consistent at around 7.4% of the UK total. OBR data shows a more consistent share, post 1999-2000, but still a variation of 6.6% over the short period 2000-01 to 2003-04.

Furthermore the economic and government finance impact of a higher/lower income tax level in Scotland on the top 1% of tax payers is very important as the top 1% of income tax

payers typically brings in up to 20% of all income tax revenues. Furthermore these taxpayers are probably the most mobile section of society.

As elsewhere, it will be very difficult to estimate in advance what the impact of any income tax change will be in attracting or repelling these taxpayers and what might be the optimal change to the tax rate to introduce.

John McLaren
CPPR

Table 1: Annualised growth rates, in constant price terms, GDP per capita

Countries	<u>Decades</u>					1970-2010
	70s	80s	90s	00s	(00 to 07)	
Ireland*	3.3	3.3	6.0	0.7	3.0	3.3
Norway	4.1	2.1	3.1	0.6	1.6	2.5
Portugal*	3.6	3.1	2.7	0.2	0.6	2.4
Finland	3.4	2.6	1.7	1.4	2.9	2.3
Iceland	5.2	1.6	1.5	0.9	3.1	2.3
Austria	3.5	2.0	2.2	1.1	1.7	2.2
Japan	3.2	4.1	0.9	0.7	1.5	2.2
Spain*	2.6	2.6	2.5	0.7	1.8	2.1
United Kingdom	1.8	2.6	2.6	1.1	2.4	2.0
Belgium	3.1	1.9	1.9	0.8	1.4	1.9
Germany	2.8	2.2	1.6	1.0	1.4	1.9
OECD**	2.5	2.3	2.0	0.9	1.7	1.9
Canada	2.8	1.6	1.9	0.8	1.5	1.8
Greece*	3.6	0.2	1.8	1.8	3.7	1.8
Netherlands	2.3	1.7	2.5	0.9	1.6	1.8
USA	2.2	2.3	2.2	0.6	1.4	1.8
Scotland	1.5	2.1	2.2	1.2	2.4	1.8
Australia	1.3	1.5	2.4	1.5	2.1	1.7
France	3.1	1.8	1.5	0.5	1.1	1.7
Italy	3.3	2.4	1.6	-0.2	0.7	1.7
Sweden	1.6	1.9	1.7	1.5	2.6	1.7
Denmark	1.9	2.0	2.2	0.2	1.3	1.6
New Zealand	0.7	1.3	1.6	1.3	2.1	1.2
Switzerland	1.1	1.6	0.5	0.9	1.2	1.0

Sources: OECD, Scottish Government

- EU 'cohesion' countries. ** OECD here incorporates an estimate over 34 countries.

The Economic and Financial Implications of the Scotland Act

Prepared for Scottish Parliament Finance Committee 'Round Table', 24 April, 2013

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Introduction

This short note sets out a number of issues relating to the financial and economic implications of the Scotland Act. It draws on evidence previously given by the author to the relevant committees of the Scottish and UK Parliaments in the period during which the legislation was under scrutiny.

The note focuses exclusively on issues raised by the devolution of partial competence over income tax. Moreover it tends to emphasise the “downside” risks associated with the financial provisions of the Scotland Act.

It is clear that a number of important details surrounding the implementation of the new financial arrangements have yet to be agreed between the Scottish and UK Governments, in particular the methodology for adjusting the block grant to ensure the principle of “no detriment” is achieved.

In general the Scotland Act represents a modest reduction in the role of the Barnett formula in determining the revenues accruing to the Scottish Parliament with which to finance the spending policies of the devolved government. To the extent that the Barnett Formula was predicated on considerations of fiscal ‘equalisation’, the Scotland Act represents a shift away from that approach.

1. The Financial Implications

- 1.1 It seems to be agreed that the method of financing Scottish public spending to be introduced by the Scotland Act introduces, for the first time, categories of *revenue risk* that are absent from the current “full Barnett” model.
- 1.2 Two specific categories of risk arise. The first is that relating to the underlying rates of growth and stability of the new income tax resource that will partially fund public spending in Scotland, and will substitute for a share of the Barnett-determined block grant. The second risk relates to the short-term volatility (up or down) in Scottish public

spending arising from incorrect forecasts of Scotland's income tax yield which, under the legislation, require an adjustment to be made subsequent years' block grant.

- 1.3 The main risks on the revenue side therefore arise from (i) uncertainty about the accuracy of forecast income tax receipts (and subsequent block grant adjustment); (ii) uncertainty about the composition and rates of growth of the Scottish income tax base relative to the average for the UK as a whole; (iii) uncertainty about the incidence and/or scale of asymmetric shocks hitting the Scottish economy that impact on the tax base; (iv) uncertainty about the revenue effects of altering the Scottish rate of income tax; (v) uncertainty about the consequences of changes in income tax introduced by Westminster; (vi) uncertainty about the fiscal headroom the government will have in any single year to borrow to offset an unanticipated shortfall in tax income or repay the excess revenues due to UK Government as a result of previous overestimations by OBR in forecasting Scottish income tax yield. This is not an exhaustive list.
- 1.4 These risks are related to a combination of decisions made by the UK and Scottish Governments, and a raft of exogenous factors that are difficult to predict, although in some cases conditional probabilities may be estimated – i.e. these risks are not mutually exclusive, and some may be positively correlated.
- 1.5 Some element of the short-term revenue risk is addressed by establishing a non-capital borrowing facility of £200 million (in any single year subject to an overall cap of £500 million). However we simply cannot know in advance if this will provide sufficient insurance to offset the revenue risks above, and others. Ultimately this will depend on the accuracy of OBR forecasting on which there is no track record in relation to the Scotland 'segment' of the UK economy; the precise structure and yield of the Scottish tax base (ratio between high-rate and low-rate tax payers); and the attitude of government to revenue risk (for instance if the Scottish Parliament may decide to reduce the level of public spending to create a contingency reserve).

- 1.6 There is no *a priori* reason to be confident that the borrowing facility will be adequate to smooth unanticipated revenue shortfall. For instance the OBR has recently downgraded its (virtually in-year) forecast of Scotland's income tax yield by 7% for the current (2013-14) fiscal year. As matters stand the £200 million ceiling on annual contingency borrowing against incorrect OBR revenue forecast would be insufficient to compensate for the £300 million outturn income tax shortfall now being forecast, implying that an "immediate" cut in Scottish Government public spending, or tax rise equivalent, of at least £100 million (more if the ceiling of £500 million was reached) in the next financial year would be triggered.
- 1.7 The Scotland Act provides no "exceptional circumstances" clause that could be triggered should revenue from Scotland's income tax decline unexpectedly (or the financial adjustment increase unexpectedly) beyond a specified threshold that cannot be accommodated by the borrowing facility and which otherwise will induce public spending cuts that undermine cross-UK equity of access to public services. In such circumstances spending would have to be reduced immediately, or taxes increased as early as practicable.

2 The Economic Implications

- 2.1 The financing arrangements set out in the Scotland Act have important economic implications.
- 2.2 The principal economic effects of the new financing arrangement fall under four principal headings: (i) impact of increased accountability and efficiency gains by better matching revenue-raising capacity to spending capacity; (ii) effects generated by any change in total revenues accruing to the Scottish Parliament as a consequence of the new funding regime; (iii) labour market effects generated by changes in the Scottish rate of income tax; (iv) the impact of new (capital and non-capital) borrowing powers.
- 2.3 In the fiscal federalist literature it is axiomatic that assigning tax-raising responsibility to a parliament commensurate to its spending will, by

improving accountability, raise the efficiency of public spending. The modest increase in the matching of revenue-raising to spending should therefore produce a modest efficiency gain, albeit no “rule-of-thumb” exists to suggest how important this effect will be.

- 2.4 Unanticipated changes in government revenues pose potentially serious challenges for public policy and the performance of the economy. If significant and/or recurring over a longer period such changes may impact on the long run growth prospects of the economy.
- 2.5 Changes in the rate at which income tax is levied clearly will impact on the labour market, where both “income” and “substitution” effects will combine to change the yield from Scotland’s income tax. It is not possible to assess, ex ante, which of these effects will dominate and, consequently, the impact on tax revenues.
- 2.6 Additionally deleterious economic effects are likely to follow should changes in the rate at which Scottish income tax is levied occur regularly (though unpredictably) to meet the budgetary implications of fluctuating economic circumstances or to offset the impact of tax revenue forecast errors.
- 2.7 All borrowing undertaken by the Scottish Government as permitted under the Scotland Act must be serviced and repaid from current receipts. Borrowing for capital investment (capped at £2.2 billion) rests on a fairly narrow own-resources tax base. Accordingly the required rate of return to be applied to capital investment financed by borrowed capital should be set sufficiently high to reflect the partial nature of any additional annual income tax revenues generated by that investment that accrue to the Scottish Government.

Policy-Making Post Scotland Bill

In this note I make a couple of points – probably rather obvious – about how policy-making will be different Post Scotland Bill. In particular I identify two important new areas to which consideration will have to be given by policy-makers.

Given time constraints they are bullet points rather than fully developed arguments, and, moreover, all I am trying to sketch are broad considerations to be thought about. I am not offering detailed calculations. It is all rather broad brush.

1. Additional Consideration - Tax Base

While Scotland did have some tax raising and tax rate setting powers prior to Scotland Bill – e.g. Local Authorities could in principle set tax rate (though have been severely constrained by central government in recent years) – the bulk of expenditure was funded from a block grant, the size of which was ultimately determined by the tax revenue raised in UK on a variety of different taxes. In deciding how to spend this money, the Scottish Government and Scottish Parliament would be trying to achieve their various objectives – growth, fairness, health sustainability etc. While some of these objectives (e.g. growth) could have an impact on the tax base in Scotland – and, in particular, the income-tax base – the connection between the Scottish income tax base and the expenditure available in Scotland via the block grant would be sufficiently weak that it would have been reasonable to ignore it and focus just on how various spending policies affected the major objectives.

One important difference in a post-Scotland Bill world is that the Scottish Government and Scottish Parliament will now have to pay some attention to how policies affect the Scottish income tax base, since now, the larger the Scottish income tax base the larger is the amount of money available to spend pursuing all the objectives of growth etc. While this should not be a dominant consideration, nevertheless, at the margin, if there was to be a choice between two policies, one of which was likely to grow the Scottish income tax base and the other didn't, there would now be a reason to prefer the former.

There will also be some trade-offs to juggle and to think through. E.G. a policy that grew the incomes of relatively well-to-do individuals may not be immediately very attractive from a fairness point of view, but, if it generated sufficient extra tax revenue which could be spent on the poorest people this may overall be a pro-fair policy.

A corollary is that there will have to be some build-up of expertise in civil service and in Parliament on what policies are effective in growing the income tax base, and which might have a negative impact. The obvious ones to look at are investment, education, health etc.

2. Setting The Income Tax Rate

The other major new policy decision is setting the basic rate of income tax in Scotland. Stated at its simplest, under the Scotland Bill the current basic rate of income tax will be halved with the income tax revenue from this halved rate accruing to HM Treasury. The Scottish Parliament will have the powers to set a basic tax rate that is higher than this halved rate and will keep all the income tax revenue arising from any such additional rate it sets.

So what rate should it set? There are three broad options to consider:

- a. Restore the existing rate
- b. Set a rate that is higher than the existing rate
- c. Set a rate that is lower than the existing rate.

There are a number of factors to consider in making this decision, but I will focus on just one - tax revenue

- Tax Revenue

The primary purpose of taxes is to raise revenue, so how would tax revenue available to a Scottish Parliament vary under these three options?

- a. As a first approximation we could say that if the Scottish Parliament restored the basic tax rate to its existing level then it would get roughly half the income tax revenue accruing in Scotland at the existing rate – with other half going to HMT.

So what would happen to Income Tax Revenue accruing to the Scottish Parliament if it were to choose either of other two options and either raise or lower the tax rate?

Answering this is quite complex because with a progressive income tax, there are many tax rates, bands etc. and the precise answer will depend on these details but in general we think of an increase in the tax rate having two effects on tax revenue that go in different directions:

- (i) It raises tax revenue because, for a given tax base, the higher the tax rate the greater the tax revenue raised;
- (ii) It lowers tax revenue because, through a variety of channels, the higher tax rate is likely to cause the tax base to shrink, and so less revenue is raised with any given tax rate.

In general the first effect dominates the second when tax rates are low, leading to tax revenue increasing the higher the tax rate, while the second dominates the first when tax rates are high causing tax revenue to fall when tax rates increase¹.

On the basis of both empirical evidence and theoretical considerations economists think that most modern economies with relatively low tax rates operate in the region where tax revenue increases the higher the tax rate².

There are two factors that complicate matters when trying to assess how these considerations play out in the context of decisions by the Scottish Parliament on what tax rate to set.

¹ The Committee may be familiar with concept of the *Laffer Curve* which is a theoretical construction showing the relationship between tax revenue in a given country and “the” tax rate in that country. It shows tax revenue being zero when the tax rate is zero and also when the tax rate is 100% - since, it is assumed, the tax base shrinks to zero if all income is taxed away. Between these two points tax revenue is initially increasing with the tax rate and then, beyond a certain point it falls. So the relationship between tax revenue and the tax rate takes the form of an inverted U. This is consistent with the ideas sketched out here.

² In the language of Laffer curves, most economists think that economies operate on the rising part of the Laffer curve.

- ❖ *Shared tax base.* If the Scottish Parliament were to cut the tax rate below the existing rate then it would bear all the loss of revenue arising through effect (i) above but would get only a fraction of the gain arising from the larger tax base arising through effect (ii) since some of this would accrue to HMT. So cutting the tax rate would cause revenue to fall more sharply than if tax base were not shared. Conversely if Scottish Parliament were to increase the tax rate then it would gain all the additional tax revenue arising through effect (i) above but suffer only a fraction of the effect of the contraction in the tax base since some of this would be borne by HMT. So an increase in the tax rate will cause tax revenue to increase more sharply than if tax rate were not split. Taken together this suggests that tax revenue will respond quite strongly to changes in the tax rate and, other things being equal, would imply that the Scottish Parliament would have an incentive to raise the tax rate.

- ❖ *Differential Tax Rates* However if the Scottish Parliament were to set a basic tax rate that was different from the current rate it would also be setting one that, other things being equal, was different from that in the rest of UK. This could be argued to have three effects:
 - Increased Responsiveness of Tax Base It could be argued that if Scotland had a lower tax rate than rest of UK then, over and above all the normal channels that might cause the tax base to expand in response to a lower tax rate, there would be an additional one since there would be an incentive for higher income people paying taxes to relocate to Scotland. Conversely the tax base could contract more sharply in response to a higher tax rate as some high income people leave to find employment in rest of UK. Taken together this suggests that tax revenue might respond rather weakly to changes in the tax rate and, other things being equal, would imply that the Scottish Parliament might have an incentive to cut the tax rate.
 - Increased Business Costs One effect of having different tax rates in Scotland from rest of UK is that companies that have operations spread across UK could find that they come under pressure from unions/workers to either re-locate workers to the lower tax regime or else negotiate differential rates of pay to compensate for differences in tax rates. This cost of doing business in more than one location could induce companies to consider consolidating in one region. Since Scotland is a smaller market than rest of UK this could lead to some tax base moving out of Scotland just by virtue of the tax rate being different here – whether it is higher or lower.
 - Increased Avoidance Opportunities Whenever tax rates differ there are incentives for companies and individuals to find artificial/paper means of lowering their tax bills by channelling their income through low tax jurisdictions. This could cause tax revenues to fall in both Scotland and rest of UK.

While these latter two points suggest that one should think carefully about the consequences of any policy that involves setting tax rates that are different from those in the rest of UK, they should not be interpreted as advice not to do so.

To illustrate some of the ideas discussed here, in the Appendix I show two Laffer curves. The first illustrates the relationship between the total income tax revenue raised on the Scottish income tax base as a function of “the” income tax rate. The assumption is that all this tax revenue accrues to a

single tax authority. So this shows what might be called the Pre-Scotland-Bill Laffer curve, and shows what income tax revenue would have accrued to HMT as a function of the UK tax rate.

In the second diagram I show in addition the Laffer curve that represents how when the Scotland Bill is in operation, the tax revenue accruing to the Scottish Parliament would vary as a function of the tax rate facing Scottish tax payers. I call this the Post-Scotland-Bill Laffer Curve.

Conclusions

Policy making after the Scotland Bill comes into operation will raise important new issues on which decisions will have to be taken and these in turn raise complex issues to which thought will need to be given and, where possible, empirical evidence gathered.

David Ulph
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April 17th 2013

APPENDIX TO NOTE by Professor David Ulph on Post-Scotland Bill Policy Making

To illustrate some of the ideas in my note, in this Appendix I show two Laffer curves. The first illustrates the relationship between the total income tax revenue raised on the Scottish income tax base as a function of “the” income tax rate. The assumption is that all this tax revenue accrues to a single tax authority. So this shows what might be called the Pre-Scotland- Bill Laffer curve, and shows what income tax revenue would have accrued to HMT as a function of the UK tax rate. I denote this by $R(t)$. I should stress that this is purely theoretical and it is not based on any particular data/calculations. It shows the “usual” Laffer curve whereby tax revenue is zero when the tax rate is zero and when it is 100%. The tax rate labelled t_0 represents the current tax rate prevailing in Scotland as part of the UK tax system, and $R(t_0)$ represents the total income tax revenue accruing from Scotland’s tax base as a result. For the reasons given above I have shown t_0 lying on the rising part of the Laffer curve.

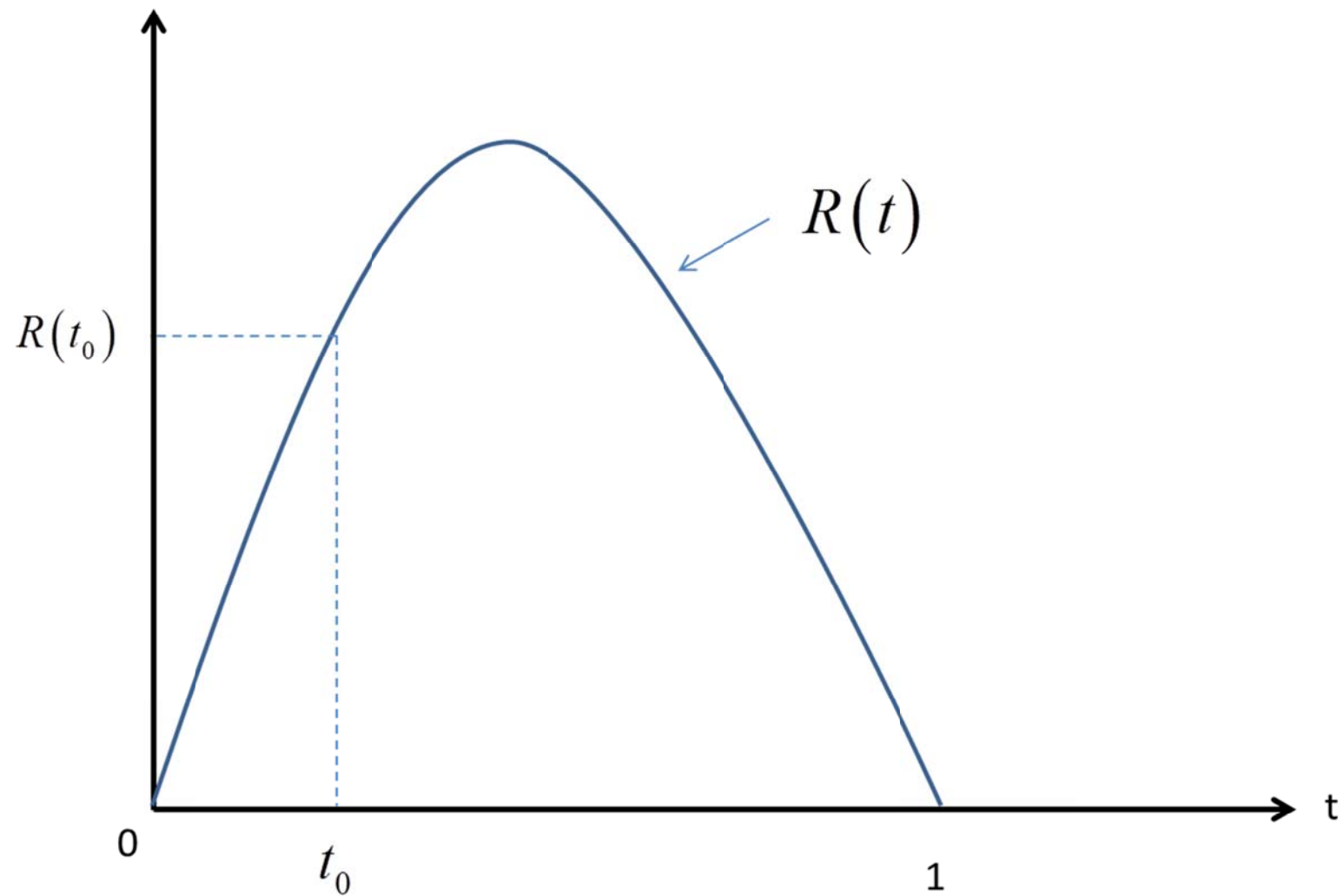
In the second diagram I show in addition the Laffer curve that represents how tax revenue accruing to the Scottish Parliament would vary as a function of the tax rate facing Scottish tax payers. I call this the Post-Scotland-Bill Laffer Curve and denote it by $R_s(t)$. This shows that tax revenue is zero in the unlikely event that the Scottish Parliament chooses to live with the tax rate in Scotland being half what it currently is and all tax revenue accruing to HMT. It shows that if Scottish Parliament chooses option (a) and just restores the existing rate then, to a rough approximation, it gets $\frac{1}{2}R(t_0)$. Finally if the Scottish Parliament sets a tax rate of 100% then it, and HMT, get zero income tax revenue from Scotland.

For reasons I have given, at the current tax rate, t_0 , the Post-Scotland-Bill Laffer curve could be steeper or flatter than the pre-Scotland-Bill Laffer curve.

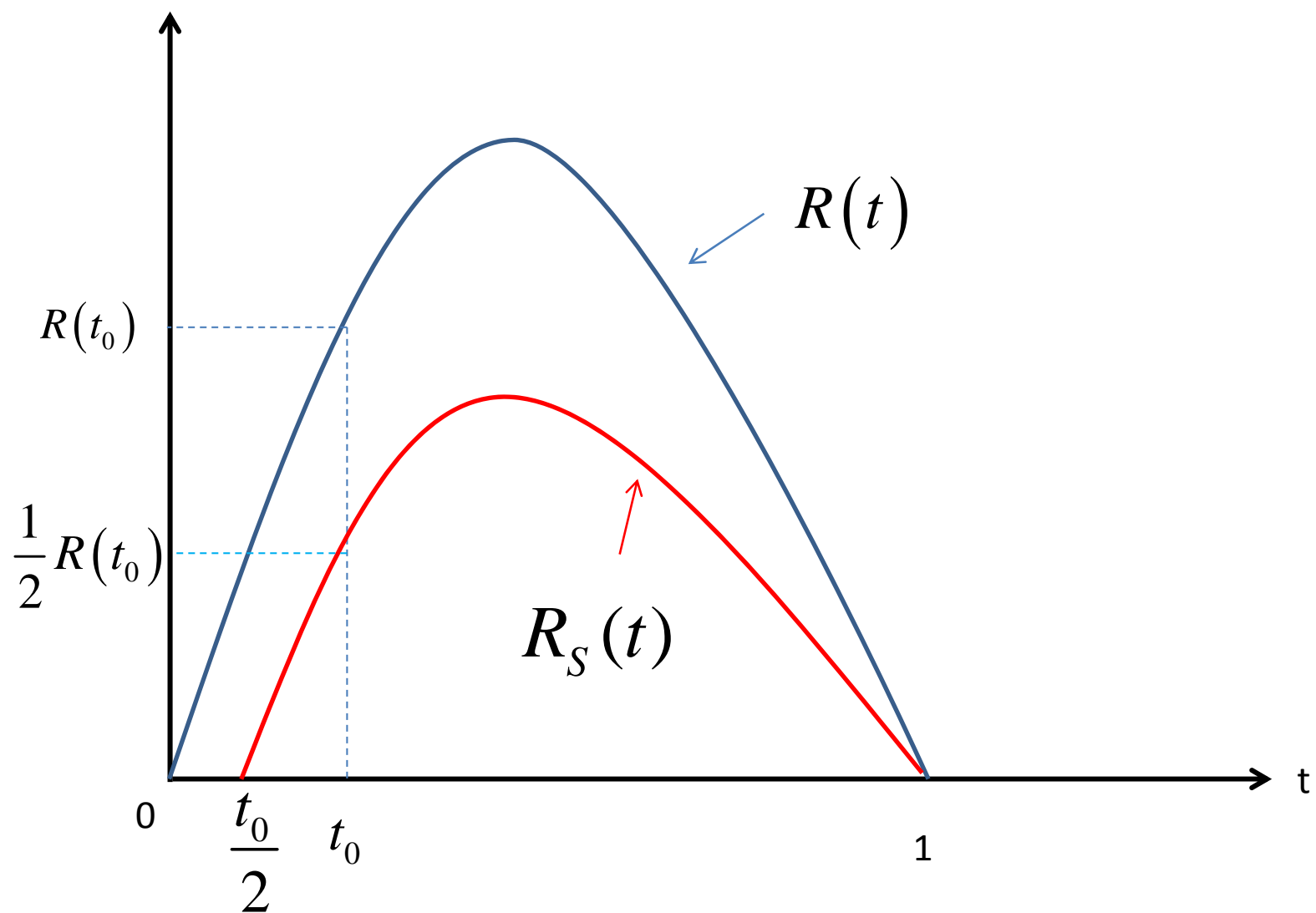
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April 17th 2013

Pre-Scotland-Bill Laffer Curve



Post-Scotland-Bill Laffer Curve



The Economics of the Land and Buildings Transaction Tax – a paper submitted in evidence to the Finance Committee, Scottish Parliament, April 2013

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1. Introduction

A key feature of the Scotland Act 2012 is the devolution of Stamp Duty Land Tax (SDLT) and its replacement, the proposed Land and Buildings Transaction Tax (LBTT), presently going through the legislative process. The Finance Committee is scrutinising this legislation and its focus thus far (e.g. the Stage 1 Report by the committee) has, understandably, focused on a range of practical, legal financial and otherwise necessary conditions of establishing the new tax. Under the provisions of the proposed new tax in Scotland, for instance, the Block Grant will be reduced by the expected amount of the tax (subject to ongoing inter-governmental discussion – Hudson and Evans, 2013). In this short paper I want to step back and highlight wider implications of taxing housing transactions. First, however, the background to the two taxes is set out.

2. Background

SDLT is a tax on land and property transactions and in its current form has been in place since 2003, though stamp duties are in fact ancient taxes. Property transaction taxes are commonplace internationally and, like local property taxes, this is because of the ease and convenience of taxing immobile property (though there are economic arguments, too). The key features of SDLT are, first, its so-called ‘slab’ nature – different tax rates are applied progressively as the value of property rises but taxpayers *only* pay the rate to which they apply and on all of the property value, unlike, for instance, with income tax. A zero rate currently applies for residential properties below £125,000.¹ Andrew et al (2003) have pointed out that this leads to bunching of property prices around tax thresholds, it increases the user cost of capital (i.e. the transaction cost element of the real cost of holding capital in the form of residential investment)² and by increasing the cost of transacting, may also affect mobility rates and even increase house price volatility. Andrew and colleagues also argue that the interaction of nationally set threshold tax rates and considerable regional divergence in average house prices means that the tax has significantly different regional impacts.

A second feature of the tax, in terms of revenue³ raised is that it is highly pro-cyclical and therefore unstable and (even) unpredictable in the context of a cyclical housing market. This is because revenue depends on the product of the tax rate applied multiplied by house prices multiplied by transactions. A feature of the recent market

¹ Current (residential property) rates for SDLT are: <£125,000 = 0%; £125,000-£250,000 = 1%; £250,000 - £500,000 = 3%; £500,000 - £1m = 4%; £1m - £2m = 5% and over £2m = 7%.

² This can be derived from first principles but essentially covers the sum of transactions costs, the rate of return that could be earned on other investments of similar risk and liquidity, on-going property taxes and depreciation, minus the expected rate of capital gains (the latter *reducing* the user cost). The user cost is also adjusted for inflation and taxation.

³ Importantly though, the tax is counter-cyclical at the margin for individual buyers in terms of its effect on individual transactions costs – see main text discussion of Stephens (2011)

downturn period has been for prices not to adjust downwards much in nominal terms but rather to be characterised by a quantity adjustment through large-scale reductions in volumes transacted – and this has impacted significantly on total revenues (see Table 1 below). The OBR projects increases in Scottish residential property tax receipts going forward (Hudson and Evans, 2013) but this is in reality a somewhat speculative assessment of the future performance of the Scottish housing market and the timing of its recovery.

A third feature of the SDLT is that successive governments have extensively used SDLT to intervene in the housing market for wider economic reasons. While it is generally true that there are few levers that quickly affect the housing market, the main remaining instruments are interest rates and SDLT. In the past, Governments have varied tax rates to encourage investment in low value areas and they have offered temporary tax holidays and rate cuts as economic stimuli. A recent draft working paper by economists at the LSE (Best and Kleven, 2012) that models these interventions relative to the normal working of the tax, suggests that these have had large though temporary impacts that subsequently wash out (i.e. rises then falls in transactions in response to the temporary incentive).

Table 1 Scottish SDLT Revenue (2007-08 to 20011-12)

2007-08	£650m (£340m)
2008-09	£320m (£185m)
2009-10	£250m (£135m)
2010-11	£330m (£165m)
2011-12	£275m (£155m)

Source: GERS 20111-12

Note figure in brackets is the domestic property element of revenue – from, Hudson and Evans, 2013)

The proposed LBTT moves away from a slab structure to a progressive structure but one that still incorporates a zero rate for lower valued properties and at least two higher bands – and these rates will be decided by statutory instrument. On the basis that the tax will not be introduced until 2015 the Bill's drafters have decided not to lay down the proposed tax rates. Instead, in the earlier consultation readers were presented with two scenarios (as illustrated below - see website factsheet by Brodies (<http://brodies.com>)).

Scenario A	Scenario B
0% from £0 to £180,000	0% from £0 to £125,000
7.5% from £180,000 to £1.5 million	2% between £125,000 and £250,000
10% on prices above £1.5 million	9.5% on prices above £250,000

The two key points about these tax proposals are first, how do they relate to Scottish house prices? Second, to what extent do they overcome the problems identified by Andrew et al with the previous tax? On the first question, the key empirical issues relate to Scottish average house prices, their variation in terms of average prices

around the country and, critically, the overall distribution of house prices in Scotland. Current average Scottish house prices (CHMA, 2013) are (if mix adjusted by ONS) £179,000 (January 2013) or £150,000 (if unadjusted, February – Registers of Scotland). Under Scenario A the *average* house price would pay no LBTT. According to the Registers of Scotland data there are considerable inter-local authority differences in house prices. House prices vary by as much as 100% in different parts of the country according to a snapshot of Registers data published by CHMA - from less than a £100,000 in North Ayrshire to more than £230,000 in East Renfrew⁴. This implies under both scenarios that specific local areas of Scotland will be de facto exempt from the tax. The precise tax rates and schedule chosen, in trading off revenue-raising and market incentives, will also need to look to the overall house price distribution. As with all taxes related to value (e.g. the revaluation problems facing domestic rates and arguably the council tax), it is essential that these rates are regularly updated to capture moves in the level and distribution of property values. This is further discussed below.

This suggests that, while a tax such as the LBTT, operating progressively and at the margin rather than a slab, will reduce the precipice effects and therefore clustering of house prices, it cannot avoid the procyclical revenue volatility issue, nor can it avoid the regional affordability effects arising from different levels of local house prices.

3. Transactions Taxes and the Housing Market

Taxes like LBTT clearly add to the transactions costs of moving and therefore to the user cost of housing capital. The Mirrlees Review wanted to get rid of transactions taxes altogether on the grounds that value-based sales taxes simply increase the cost of doing business and reduce efficiency. Mirrlees instead argues that it would be better to tax investment returns and consumer services from housing directly and exclusively (we return to this broader debate in the penultimate section). Excessive tax rates may well inhibit mobility important to the functioning of the economy but on the other hand, as a tax on fixed property and hard to evade (in general), it is attractive from a revenue collection point of view. The proposed LBTT is progressive in the sense that it (crudely) increases with house prices and to the extent they proxy for wealth that might be fair enough. However, by increasing the transactions costs attached to entering home ownership (if the entry level price was over the nil rate threshold) then this would clearly impact on specific household types reducing entry into home ownership and reducing their opportunities.

Apart from the critique offered above by Andrew et al (2003) and Mirrlees, other commentators have also weighed in to this debate. The Joseph Rowntree Foundation Housing Market Task Force (Stephens, 2011) stressed the fiscal drag aspects of SDLT (i.e. more properties become eligible to pay higher rates of tax as property values rise while thresholds lag behind because they do not automatically or regularly adjust). Stephens notes that, comparatively, the UK has low transactions costs for home purchase when contrasted across Europe. These findings are supported by a recent study by the OECD⁵. Stephens concludes that the tax should be reformed along LBTT

⁴ Small numbers so treat with caution – CHMA, 2013.

⁵ Although a more nuanced picture of comparative tax rates comparing the UK with Denmark, Germany, the Netherlands and the USA emerges from Oxley and Haffner (2010). The larger OECD study (2011), however, suggests overall transaction costs for house purchase varying from 4-14% in the OECD – with the UK at the low end of the estimates.

lines but that it must be regularly updated with consumer prices if it is to retain its desirable (automatic stabiliser) counter-cyclical features – as property price rose above inflation they would become liable for higher transaction taxes but when house prices fell in real terms they would become liable for lower tax rates. Depending on the structure of rates this would reduce the need for tinkering with rates, holidays and other temporary adjustments. It suggests therefore a case for a more progressive set of regularly updated tax rates than would appear to be presently offered by LBTT.

4. General Equilibrium Issues

It is risky to only consider the narrow or direct aspects of a transactions tax on housing sales. There are a number of these general equilibrium considerations to acknowledge⁶. First, taxing property in general helps to widen the tax base, and, if designed well, may reduce anomalies and distortions that flow from the privileged status that owner-occupied housing enjoys in fiscal terms – perhaps leading to over-investment in housing (especially in comparatively unproductive second-hand housing)⁷. Widening the tax base may allow tax authorities to raise the same revenue with lower marginal rates (although this would have second round redistributive consequences)⁸. Second, the housing sector is an interdependent system, and the non-neutrality of the tax treatment of residential investment by owners and private landlords needs to be recognised⁹. Indeed, in its quest to support institutional investment in private renting, HM Treasury has changed the SDLT rules for bulk purchases by Real Estate Investment Trusts so that they can be incentivised to invest in the sector. This does not, however, apply to the much larger Buy to Let sector.

5. Wider Housing Taxation Questions

The 2010 Scottish housing policy statement (*Housing: Fresh Thinking, New Ideas*) explicitly recognised the costs of rising real long run house prices and of house price volatility. Implicit is that the cumulative effect of favourable tax treatment is at least in part to blame (along with lending policies and unresponsive supply). Deregulation has also taken away policy instruments that can influence the housing market. Transactions taxes can play this role so they are a useful tactical club to have in the bag. More generally, I would agree with the Mirrlees Review that the long run position must be, regardless of the desire to reduce sales taxes in general and property transaction taxes specifically, that housing assets and service consumption should be taxed like any other normal good or asset. Otherwise we will continue to see the distortion of consumption and investment decisions to the detriment of the economy and arguably social justice. In a paper with Tony O’Sullivan last year we argued that the macroeconomic evidence is frankly hard to find that can back up the idea that supportive home ownership policies benefit the economy. There is however, amidst other negative or neutral evidence, limited support at the micro scale that subsidising home ownership might promote parenting and educational outcomes - but this is not a general basis for providing subsidy in the form of tax breaks (O’Sullivan and Gibb, 2012).

⁶ And this is before one considers alternative property taxes such as a land value tax.

⁷ Although the precise effects depend on a number of factors such as the extent to which tax advantages are fully capitalised into house prices.

⁸ Widening the net of goods and services taxed and reducing the marginal tax rates on all goods and services would redistribute the net benefits and costs of this change between different groups in society depending on their pre and post tax change consumption patterns.

⁹ Broadly, private landlords do pay something close to the Mirrlees proposal.

The LBTT will not solve the problems of the housing economy, nor will it overcome all of the problems associated with the SDLT (and the new tax should build in regular revaluation of rates) but what is being proposed is a step along the road, in a context where legislators and commentators should not lose sight of bigger picture. While recognising the real difficulties of making significant inroads into these deep-seated 'wicked' housing tax questions, in an era of scarce public resources it is surely essential to keep the debate alive? It is costing Scotland and the UK to wastefully subsidise home ownership. Couldn't those tax revenues be better used?

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