reform scotland

Taxing Times:

Why Scotland needs new, more and better taxes

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About Reform Scotland

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Heather McCauley

Heather McCauley is a former senior civil servant who has worked for the New Zealand and Scottish Governments and the UK Parliament over a 30-year period. Her roles have included policy advisor to two New Zealand prime ministers from 2001 to 2012, during which time she advised on a wide range of social, economic and public sector design issues.

Heather also brings a first-hand knowledge and understanding of the Scottish context, having worked as a senior civil servant in the Scottish Government from 2012 to 2016, and consulted for various Scottish public bodies since 2018. Heather currently works independently, advising public sector leaders on medium-term strategy and organisational change, and undertaking short-term policy and research projects. Heather is an associate of Reform Scotland.

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Foreword

Tax is among the most controversial and difficult issues in politics. Most people would prefer to pay less of it, but we live in times where the demands on the public purse are growing. Scotland's overall population is ageing, while our working-age population is shrinking. We must find new revenue just to meet existing commitments, even as new commitments come on line too – such as funding a national care system. Meanwhile the Covid epidemic has raised national debt levels, and governments are also trying to help households through the cost-of-living crisis, with its consequences for heating bills, the weekly shop, and mortgages.

At moments of peril it's always tempting to avoid reform, but as Heather McCauley points out in this report, it's very difficult to see how Scotland can meet its future commitments – whatever its constitutional status - without looking afresh at the tax system, at who and what we tax, and at what the right balance should be.

Redesigning the tax system is a major task, and a delicate one, but the system we have in the UK is clearly no longer fit for purpose, and serves only to limit smart thinking. At Holyrood, too, there is scope for experimentation and adjustment – particularly, as Heather notes below, the examination of whether wealth should shoulder a greater share of the tax burden than income.

As in so much else, political vision and courage are what the nation needs in this period of change. We trust policymakers will find this contribution to the debate a useful, innovative and inspiring one.

Chris Deerin
Director
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Introduction

Like other developed countries, Scotland will face increasing pressure on its public finances in the coming years. It will need to take steps to maintain existing tax revenue and find new ways to raise revenue.[1] Public debate often focuses on spending choices, but decisions on how much tax revenue a country needs, and the way governments raise that revenue, have as much impact on people's wellbeing as the way in which revenues are spent.

Wider public understanding of the big choices in tax policy is critical if citizens are to engage with and shape what are potentially difficult choices ahead. Tax policy is, however, often seen as highly technical and complex. As a result, debates tend to focus on very specific choices – what a tax rate should be or whether a group or activity should receive a tax relief or exemption – in isolation from the wider tax system and its impact as a whole. Taxes that are levied 'directly' such as Income Tax tend to receive more attention than those that are less visible, such as consumption taxes. The taxes that are in place receive more attention than those that are not.

This paper aims to provide a non-technical discussion of how the UK and Scotland compare internationally and what the experience of other countries might tell us about some key tax design choices. It is not intended to be comprehensive – there are many in-depth studies of the UK tax system, not least the 2011 Mirrlees Review, the conclusions of which are still largely relevant today.[2] Instead, it discusses some key design questions that Scotland could consider in deciding how best to exercise its devolved tax powers, including the power to create new taxes, and what mix of reserved and devolved tax powers would be optimal for the future.

The discussion draws on examples of several countries of similar size to Scotland that have significantly reformed their tax systems in different ways, particularly New Zealand and some of the Nordic countries. New Zealand is generally recognised to have one of the more simple, efficient and transparent tax systems amongst developed countries, while the Nordics provide examples of countries that raise high levels of revenue to fund high levels of public spending. The paper also draws on cross-country reviews to illustrate how the current UK and SG tax systems compare more broadly. In the end, however, tax policy is highly context-specific. International examples are intended to illustrate some of the key choices available rather than recommend specific models to adopt.

Scope of this paper

This paper focuses on the three largest or potentially largest sources of tax revenue – income, consumption and wealth. It does not consider the taxes whose *primary* objective is to change behaviours, such as alcohol, tobacco, gambling, or sugar taxes,

[1] This paper considers taxes as defined by the OECD: "compulsory unrequited payments to general government or to a supranational authority" (OECD, 2020b). This includes compulsory social security contributions but not other forms of government revenue such as fees and charges; it includes tax expenditures and reliefs that reduce tax liabilities, but not the use of tax systems to pay benefits that exceed a tax liability.

[2] Mirrlees et al. (2011). *Tax by design*, Institute for Fiscal Studies. Available at: https://ifs.org.uk/publications/mirrleesreview

where revenues would be expected to be relatively small and to decline if those objectives are achieved.

This means that it does not consider environmental taxes in any detail. While these will be important contributors to climate and biodiversity goals they are, with the possible exception of a carbon tax, less significant sources of revenue. If successful, their revenues would be expected to decline. That said, assessment of income, consumption and wealth tax options tends to focus on the implications for individuals or companies. Similar attention should be given to their environmental impacts, given the urgency of the climate and wider environmental crisis.

This paper focuses on policy objectives and choices rather than the administration of tax systems. The latter would, however, be critical to assess once specific policy options are identified since administrative feasibility and cost will influence the effectiveness and public perceptions of any options.

Finally, this paper focuses on national-level taxes, as the area that is relatively new in Scotland, and because of the extent of existing reviews and expert input into options for change in local taxation, particularly council tax. At the other end of the spectrum, it recognises that some forms of taxation can increasingly only be effective with international cooperation and, in some cases, internationally agreed and enforced 'floors' due to globalisation and digitalisation that make national-level taxation difficult or less effective.[3] Again, these are not the focus of this paper.

This paper aims to draw out some of the big tax design choices for countries in an accessible way. In doing so, it necessarily simplifies what can be a highly complex and technical field. At root, however, these choices need to be accessible to the broad public if they are to exercise democratic choice and oversight. This paper is intended to provide a starting point, not the final word, to support that wider discussion.

A note about Scottish and UK tax powers

The Scottish Government receives its revenues from a mix of UK Government and SG taxes – for day-to-day (non-investment) funding, around two-thirds of the Scottish Government's budget comes from the 'Block Grant' received from the UK Government and one-third from devolved taxes (Phillips, 2021).

By far the most significant national-level tax in Scotland is Income Tax on employment income – Scottish powers exclude other types of savings and dividend income, along with the tax-free personal allowance, reliefs and exemptions.[4] Scottish Income Tax

[3] For example, the recent global corporate tax agreement, signed by 137 nations to date, will allocate a portion of the corporate tax base to market countries (allowing them to tax even without a physical presence) and agree a minimum 15% corporate tax rate for the 100 largest multinationals (OECD, 2021e; IMF, 2022); the OECD now wants to harness this experience to develop a common approach to pricing carbon (see https://www.politico.eu/article/oecd-boss-digital-tax-deal-can-inspire-global-deal-on-carbon-pricing/).

[4] There are two other national-level taxes, a Land and Buildings Transaction Tax and Scottish Landfill Tax (LBTT), but these are much less significant in revenue terms. Three national-level taxes that are still to be implemented – an Air Departure Tax, tax on the commercial exploitation of crushed rock, gravel or sand, and the assignation of a portion of VAT revenues generated in Scotland.

contributes 27% of overall non-investment funding, with 5.5% contributed by other Scottish taxes (Phillips, 2021). Since Income Tax powers were devolved, the Scottish Government has made small changes to the rates and thresholds within its competence, resulting in a slightly more progressive profile. In simple terms, these mean that at lower income levels Scottish taxpayers pay slightly less income tax while middle and higher income earners pay slightly more. Overall, Scottish taxpayers pay more in income tax than they would under UKG tax policies.

The 'Block Grant' is adjusted to reflect devolved tax revenues, with the Scottish Budget reduced based on how quickly the revenues of the corresponding tax have grown in the rest of the UK, adjusted for population. If Scottish tax revenues grow more quickly, Scotland's budget position will improve; if they grow more slowly, the Scottish Budget will reduce (SFC, 2021; SG 2021c).[5]

The Scottish Parliament can also create new national devolved taxes with the consent of the UK Government and Parliament.[6] Prior to the enactment of this provision, a UK Government Command Paper set out the criteria that the UK Government would consider with regard to any proposals for new taxes - most importantly, the need to ensure that the proposed tax would not impose a disproportionate negative impact on UK macroeconomic policy or impede the single UK market (HMG, 2010).[7] The Scottish Government has not, to date, attempted to use this power.

Although not the focus of this paper, Scotland has more longstanding powers over local taxes for local expenditure – currently Council Tax and Non-Domestic (Business) Rates – and the power to create new local taxes.

The Scottish Government has repeatedly called for additional tax powers, most recently arguing for full devolution of Income Tax, National Insurance Contributions (NICs), VAT and other taxes such as Capital Gains Tax to be considered as part of the review of the Fiscal Framework in 2022 (SG 2021b & 2021c).

Tax System Objectives

In designing or reforming their tax systems, most countries start with some broad principles, often drawing on the four maxims laid out by Adam Smith in 1776. Principles usually include:

- ***Horizontal equity*** – people with similar income/assets should pay the same amount of tax

[5] Similarly, the Block Grant provides revenue for social security payments based on the growth in expenditure on the corresponding payment in the rest of the UK. If the number of recipients in Scotland grows more quickly, or entitlements are increased, additional funding has to be raised by the Scottish Government to fund this.

[6] Scotland Act 2012, s23, introducing new sections 80A and 80B into the 1998 Act, see https://www.legislation.gov.uk/ukpga/2012/11/section/24/enacted. Note, also, that despite sometimes erroneously being referred to as a tax, the Scottish Government's plastic bag charge was not introduced using this provision. While it obliges the retailer to levy a charge, the government has no legal claim on the revenues generated.

[7] Other criteria, for which the Scottish Parliament would be expected to provide supporting evidence, included the potential for the new tax to create distortions or arbitrage within the UK or tax avoidance, and the impact on compliance burdens across the UK.

- ***Vertical equity*** – those with higher incomes/assets should pay more
- ***Administrative efficiency*** – for both the government and taxpayers
- ***Economic efficiency*** – systems should, as far as possible, treat different types of income and investments neutrally, so that tax settings aren't influencing whether/how much people work, which legal form they operate in, what types of assets they buy or which sectors they invest in (minimisation of tax induced distortions).

Countries ideally want taxes to raise significant revenues in a way that improves horizontal and vertical equity while minimising economic distortions, administration and compliance costs. The principles adopted by the Scottish Government broadly follow this schema (SG, 2021d).

Generally, taxes with smaller negative effects on the economic decisions of individuals and businesses are considered to have less drag on productivity, i.e., be most 'efficient.' These are usually taxes levied on:

- broad bases – which reduce incentives to switch from one good or service or activity to another and reduce the tax rate required to raise a given level of revenue, and
- goods and services where the market (either supply or demand-side) is relatively unresponsive to price changes – so taxes change ('distort') behaviour the least.

The least distortive taxes are generally considered to be recurrent taxes on immovable property (e.g. annual property taxes), followed by consumption taxes and then other property taxes. Income taxes (personal and corporate) are regarded as amongst the most distortive taxes economically (OECD, 2010a) with transaction taxes, including on land and building transactions, particularly inefficient.[8] For these reasons, advice from organisations such as the OECD and European Commission has tended to advocate a 're-balancing' of the tax mix, including a shift away from relatively distortive corporate and personal income taxes and other taxes on labour, towards more growth-friendly taxes such as property and consumption taxes (e.g., EC, 2014).

There is increasing awareness that equity needs to be thought of more broadly than in the past. Changing demographics and trends in income and wealth distribution have prompted an increasing concern about intergenerational fairness – including the impact of the tax system on the longer-term distribution of wealth. Equity also needs to take account of the effects of revenue-raising for disadvantaged groups. Historical and current discrimination have shaped the factors that determine individual and household income, savings, consumption and wealth and, as such, tax settings can reflect and perpetuate existing biases. Markers of disadvantage need to be systematically considered in tax policy assessment (Estevão et al, 2021; Chye-Ching and Taylor, 2019).

[8] The UK's Mirlees Review recommended against all kinds of transactions taxes (such as stamp duties, input taxes and turnover taxes) for this reason (Bangman et al. 2020).

The urgency of the climate crisis and biodiversity loss means it is increasingly important to consider the impact of taxes on climate change and wider environmental outcomes. This applies not only to taxes that are focused on environmental harms or goods, but all types of taxes including income, consumption and wealth taxes, as will be discussed later in this paper.

Finally, the importance of a sustainable and resilient tax base has been highlighted by recent crises and is likely to become more important still with the likely increase in environmental and related shocks over the coming decades. Some tax revenues are more volatile in response to the economic cycle, while others are more stable. Tax design can, however, compound this. Historically, for example, consumption taxes such as VAT have tended to be one of the most stable revenue sources relative to the economic cycle. Many countries, however, saw significant falls in VAT revenues as the share of government consumption increased and private consumption shifted from luxuries and services toward necessities, which often have zero or reduced rates during and following the Global Financial Crisis. In contrast, shutdowns in response to the Covid pandemic resulted in plummeting consumer spending in specific sectors such as tourism and hospitality, rather than more broadly.

The structure of each tax individually, as well as the mix of taxes across the system as a whole, will therefore have a significant effect on the resilience of revenues in response to cycles and shocks of different kinds. Countries need to carefully consider how the structure of their systems, including different rates on different goods, affects the resilience of revenues and the vulnerability of their taxes to different kinds of shocks.

Chapter 1: We need to fundamentally re-think our tax systems

Governments in the UK and Scotland will need to find ways of raising additional tax revenue in the coming years. Structural changes are creating increased demand for government spending while, in some cases, eroding existing revenues. Further 'tinkering' will not be sufficient; a much more fundamental redesign of tax systems is required.

Tax revenues will need to rise

It is widely recognised amongst most analysts, if not acknowledged by all political parties, that taxes will need to increase in the years ahead.

Most immediately, the cost-of-living crisis has been described as an "unprecedented" threat to the health and wellbeing of people in the UK.[9] Inflation hit 9% in May 2022, with the Institute for Fiscal Studies (IFS) estimating the rate for the poorest 10% of household being closer to 11% compared to just under 8% for the richest households,[10] and the Bank of England forecasting a further rise to 10% this year.[11] Both wages and adjustments to social security benefits are failing to keep pace with inflation. In March 2022, real household income per person was projected to fall by 2.2% in 2022-23, the largest fall on record going back to 1956-57.[12]

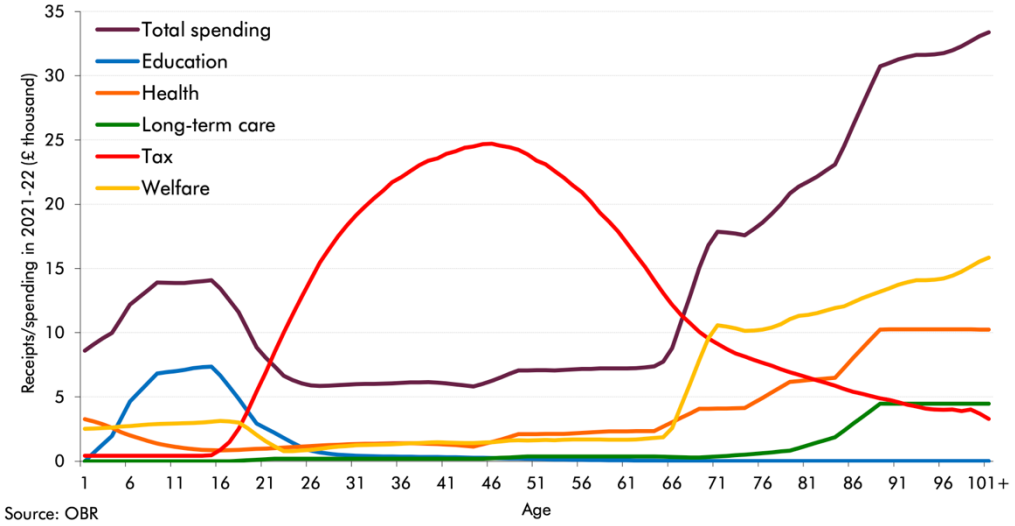
The cost-of-living crisis has come on the heels of the Covid-19 pandemic. Government financial support during and following the pandemic has been critical to preventing more severe economic contractions and job losses and continues to be needed to address backlogs in public services and heightened inequalities. It has, however, left the UK and other countries with unprecedented levels of debt that will need to be addressed if they are to create the 'fiscal space' to be able to respond to future shocks.

While these recent pressures are front-of-mind, more fundamental structural changes are creating significant additional demands on public spending while, in some cases, eroding the ability of existing taxes to fund them.

Changing demographics have profound consequences for both spending and the tax revenues need to fund it. People's tax contribution peaks in middle age, at a time when they draw relatively little on public services on average, while the need for pensions and public services rises rapidly in later life, when the tax contribution reduces significantly under current UK and Scottish Government tax settings.

[9] Michael Marmot in the Guardian: https://www.theguardian.com/commentisfree/2022/apr/08/health-inequalities-uk-poverty-life-death
[10] https://ifs.org.uk/publications/16058
[11] https://www.bankofengland.co.uk/monetary-policy-report/2022/may-2022
[12] https://www.resolutionfoundation.org/press-releases/chancellor-prioritises-his-tax-cutting-credentials-over-low-and-middle-income-households-with-2-in-every-3-of-new-support-going-to-the-top-half/

Representative profiles for tax, public services and welfare spending: UK

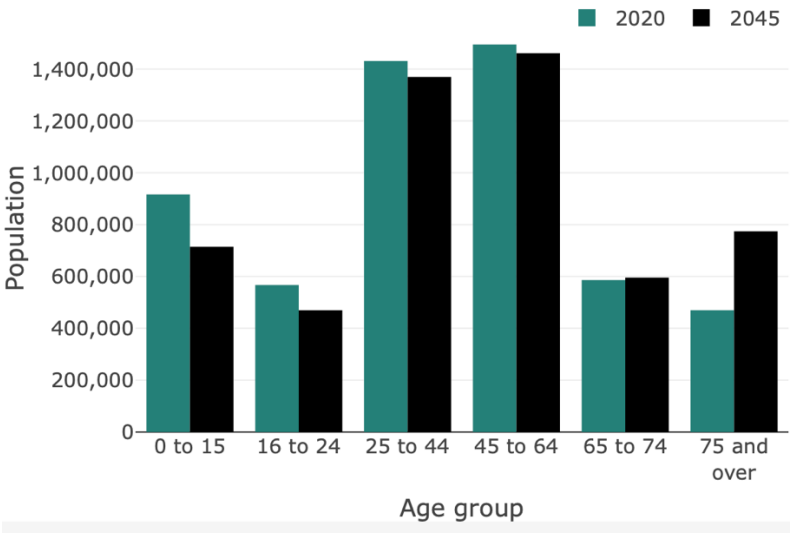


For the UK, ageing alone has been estimated to increase social security/pension spending on the over-60s by £22 billion each year from 2022 to 2030. Health cost pressures will require a real-terms health spending increase of £70 billion by 2030-31 – a 40% increase on pre-pandemic levels. These are demands that will grow faster than tax revenues under current settings and be required to pay for what the UK already has, not the extensions of social care and other public services that are also needed (Shah et al., 2022; IMF 2018; Bell and Corlett, 2019).

While these pressures will require on-going funding, the urgent need to mitigate climate change as well as adapt to changes already 'baked in' will require significant up-front investment. The exact amount required is highly uncertain, but the Office of Budget Responsibility (OBR)'s indicative scenario suggests that additional UK public sector investment for net zero may have to climb to £14 billion per year by the end of the 2020s. This will be required at the same time as demographically driven funding demands (Shah et al., 2022).

Scotland's demography means that it will experience these pressures sooner. Current National Records of Scotland (NRS) projections are for Scotland's population to begin falling in 2028 and reduce by 1.5% by 2045 while the UK population will grow by 5.8%. More serious for spending requirements and tax revenues is the projected change in the composition of the population: the next 25 years are projected to see a 68% growth in the 76+ age group in Scotland alongside almost no growth in the 31-60 age group and a 16% decline in the 16-30 year old group.

Population: Scotland



Source: National Records of Scotland

Demographics are the main driver of the largest component of social security benefits that are devolved to Scotland. Eligibility for the Adult Disability Payment depends on a disability or health condition and is not affected by income or employment. Other changes that the Scottish Government has made will expand the number of people eligible and increase payment amounts for a number of devolved benefits. In total, the Scottish Fiscal Commission (SFC) estimates that the Scottish Government will need an additional £760 million pa over and above the funding received via the Block Grant by 2026/27 (SFC, 2021).[13] Demographics will also drive increasing pressure on health and social care budgets in Scotland, with the Scottish Government estimating that health and social care spending will need to grow by 3.5% and 4% pa respectively – figures that the IFS has suggested are likely to be underestimates.[14]

Demographic change will also undermine some existing Scottish tax revenues, resulting in Scotland having relatively fewer people in the "high tax" age groups alongside relatively more people in the "high public spending" age groups. As a previous Reform Scotland paper has set out, even significantly increased immigration would have relatively little impact on this ageing process (McCauley, 2020).

All else being equal, an ageing population – and especially the shrinking of the working-age population relative to the faster-growing pension-age population – will reduce labour supply (employment, hours of work, or both) and productivity, shift demand for goods and services, and change savings and investment decisions: for example, lower savings rates and a shift towards lower-risk investments. Older people tend to receive more income from capital than employment, so an ageing population will tend to increase the ratio of capital to labour income, which is more lightly taxed in the UK.

[13] The SFC notes that these forecasts do not incorporate any changes in spending rising from the Scottish Government's replacement payments for Carer's Allowance, Attendance Allowance, Industrial Injuries Scheme and Winter Fuel Payments, which it aims to launch by the end of 2025.

[14] https://www.gov.scot/publications/scottish-government-medium-term-health-social-care-financial-framework/pages/3/; https://ifs.org.uk/publications/16067

These changes will have flow-on effects for labour and capital income, corporation and consumption tax revenues, predominantly in a negative direction.

The impact on tax revenues will impact Scotland sooner than it will the UK as a whole. The size of the workforce relative to older groups is particularly important for tax revenues under current devolved settings because Scotland's Income Tax powers only cover income from employment, not income from savings or dividends. The impact of a smaller working-age population both contributes to, and is compounded by, relatively poorer economic performance, reducing income tax receipts. Even in the relative short-term – the next four years – the SFC is expecting a decline in the size of Scotland's labour force due to slowing working-age population growth and falling labour market participation rate, with the latter mainly due to population ageing (SFC, 2021).

In the short-term, one-off events like Covid and specific policy changes can obscure these broad trends. A decrease in UK Income Taxes such as that planned by the UK Government for 2024,[15] for example, will improve the net position for Scotland by reducing the Income Tax 'off-set' applied via the Block Grant. Over time, however, it is Scotland's demographic profile together with its employment and earning performance that will determine its net Income Tax position. These effects are already evident – additional revenues have been raised by higher tax rates for middle and higher income earners in Scotland, for example, but these have not been enough to offset the faster-ageing demographic and poorer economic performance in recent years. The Holyrood Finance and Public Administration Committee has called this situation "deeply worrying" (Scottish Parliament, 2023).

Other structural changes, such as action to decarbonise the economy, while urgent and essential, will also erode some tax revenues. Norway and Denmark saw petrol tax revenues drop by 65% and 44% respectively between 2002 and 2019, while Sweden's carbon tax revenues dropped by around 17% over the same period (EEA, 2022). In the UK, revenues lost from taxes on motoring, aviation and waste as a result of decarbonisation are estimated to amount to 1.6% of GDP by 2050 (Hodgkin and Rutter, 2021), while North Sea oil and gas production revenues have been falling and their sustainability increasingly called into question (Tetlow and Marshall, 2019; Shah et al., 2022).

The Covid pandemic has also accelerated a raft of other structural changes that impact on tax revenues, from the increase in flexible working to digitalisation to the reduction in the physical footprint of firms.[16] Aspects of the design of the UK and Scottish tax systems make them particularly vulnerable to these shifts: some of the activities that have grown, such as self-employment or on-line shopping, are also more "lightly taxed." The Scottish Government reports that these changes have "struck right at the heart of the NDR tax base," for example (SG, 2021c).

[15] https://www.gov.uk/government/news/chancellor-announces-tax-cuts-to-support-families-with-cost-of-living

[16] Although it is important to acknowledge that digitalisation also creates opportunities, such as the use of technology platforms to ensure that platform service providers, such as ride sharing or accommodation-providing services, are meeting their own, and their contractors' or employees', tax obligations.

Existing forms of taxation of capital inputs and consumption will also need to be re-thought in the light of the dematerialisation of the economy. The Netherlands, for example, has set a target to have an economy that needs virtually no new materials by 2050, and a 50% reduction in primary raw material use by 2030. A European Parliament Committee has called for binding 2030 EU targets for materials use and consumption footprint including recycled content (Hunter and Pratt, 2022).[17] The Scottish Government is currently consulting the public on proposed legislation to develop Scotland's circular economy.[18] The implications of these shifts, if achieved, for tax revenues and consideration of tax treatment across investment, production, product use and waste management, including reduction of material input, reuse and recycling, are only at an early stage internationally (see, for example, Milios et al., 2021).

These challenges will face Scotland irrespective of its constitutional situation. Under current devolution arrangements the Scottish Government is primarily reliant on earnings of Scottish residents as a direct source of tax revenue, making it particularly vulnerable to demographic and economic changes that impact employment and wages. Conversely, if Scotland were to become independent, its higher levels of public spending and lower tax revenues than the UK mean it would start with a large budget deficit that would need to be addressed by cutting spending, raising tax revenue, or both (Phillips, 2022). In either case, fundamental consideration of what a resilient and sustainable tax base would look like for Scotland will be critical.

Redesign not tinkering

When additional revenue has been required in recent years, both the UK and Scottish Governments have tended to *increase existing taxes* rather than *introduce new ones*. New taxes are estimated to have contributed just over 0.5% of GDP to the UK tax take since the financial crisis – an eighth of the total. Instead, most additional revenues have come from existing taxes on income, particularly higher rates of National Insurance (NI), the introduction of and increases to VAT, and increased corporation taxes (Shah et al., 2022). Similarly, the Scottish Government has added one percentage point to the top personal tax rate but has not tested its power to raise new taxes.

As discussed in the previous section, relying on these taxes will be much more challenging in the future. This suggests that countries like Scotland and the wider UK will need to look for tax bases that will be more sustainable – that will not erode and will generate sufficient funding for current and increased future spending. There is also increasing pressure to 'spread the burden' more fairly. More than tinkering with existing tax rates, this requires a fundamental rethink of tax structures – the extent of taxation, the balance across income, consumption and wealth taxation, and scope to establish new tax bases:

> *There is a growing understanding across the world that current tax systems need to be overhauled and modernised to deal with prevalent environmental, social and economic challenges. These challenges include the technological transition,*

[17] For EU see https://www.europarl.europa.eu/news/en/press-room/20210122IPR96214/meps-call-for-binding-2030-targets-for-materials-use-and-consumption-footprint

[18] https://www.gov.scot/publications/delivering-scotlands-circular-economy-consultation-proposals-circular-economy-bill/

demographic changes, rising inequality and the triple environmental crises: climate change, biodiversity loss and the overconsumption of natural resources (EEA, 2022).

A fundamental redesign is required – of what we tax and how we tax it.

No free lunch

With the exception of the debate about the appropriate 'top' income tax rate, public discussion of tax in Scotland often focuses on ways that the current or potential future tax system could 'support' individuals, sectors or groups, implying a reduction in their tax contribution.

Any tax changes that reduce revenues need to be paid for, however, unless spending is also curtailed. While tax cuts or reliefs are often argued for on the basis that they will increase productivity and growth, they also reduce tax revenues in the short-term, at least before any stimulus effects emerge. A country cannot spend tax revenues in advance of raising them without significant additional borrowing.

This means that the onus needs to be on those arguing for changes that will reduce tax revenues, such as new exemptions or reliefs, to show how these revenues will be replaced, and for the total impact, rather than benefits for those receiving the tax cut only, to be assessed.

Similarly, if more revenues need to be raised overall, the question is not whether an individual tax or tax change is good (or bad), but whether it is better (or worse) than the reasonably realistic alternatives. Arguments can be made against all taxes; the question is not whether such arguments exist but how any proposal compares to the alternatives.

Significant tax change is difficult … but big change is possible

Significant tax reform is difficult. The complexity of tax policy can make it challenging to explain to the public why changes are needed. Governments inevitably face strong lobbies from special interests, particularly in a system with large numbers of tax reliefs and exemptions such as the UK's. The 'losers' from changes tend to be louder than the 'winners' (Tetlow and Marshall, 2019; Tetlow et al., 2020a).

Some countries, however, have shown that big change is possible. The Institute for Government (IFG) cites New Zealand as "a particularly striking international example of successful reform… (involving) wholesale tax changes" that have resulted in a comparatively broad-based, low-rate and simple system.[19] A number of Nordic countries have significantly changed their approach to taxing income, personal and capital, moving to a 'dual rate' system. In both cases, changes were supported by wider tax reforms to replace lost revenues. These and other examples will be discussed further in Chapter 4, below.

[19] Tetlow and Marshall (2019), citing Stephens R, 'Radical tax reform in New Zealand', *Fiscal Studies, 1993, vol. 14, no. 3,* pp 45-63.

Chapter 2: What can we learn from other countries?

This chapter considers the level of tax, tax rates and thresholds, and mix of taxes across countries and their broad implications for the economy and redistribution.

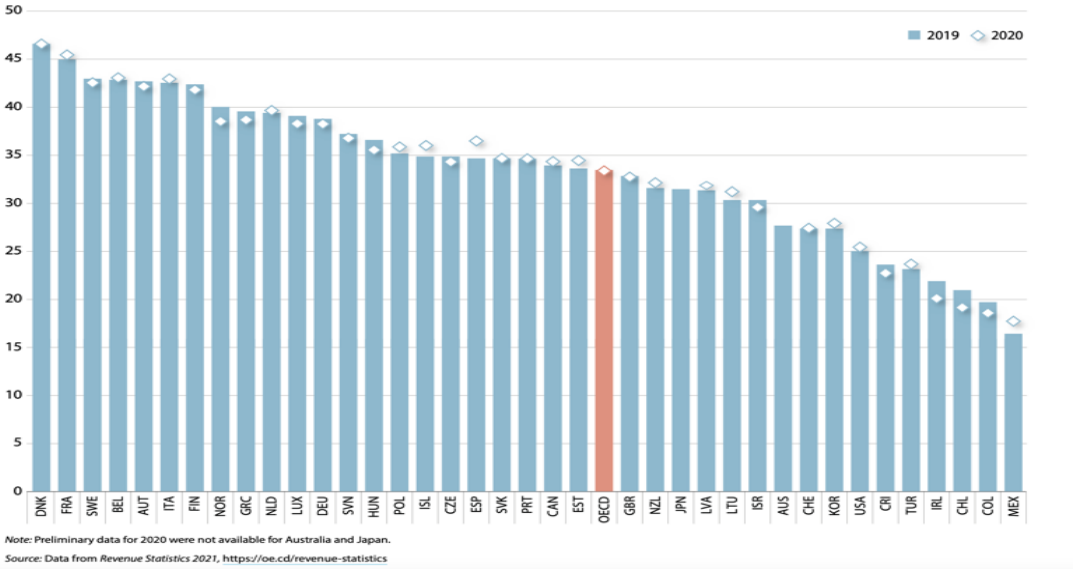
How much revenue do countries need?

In a simple sense, the amount of revenue a country needs depends on what it wants to spend to achieve its objectives, given its social and cultural preferences for redistribution and in relation to the extent of public goods that government provides. Tax policy also needs to take account of both the *direct* impact of tax and spend, and the mix of transfers and services individuals and firms receive, and the *indirect* impacts on the jobs and wages available, peoples' investment in training and skills, business creation and productivity, and on the environment, all of which will, in turn, impact on revenues.

Level of tax revenue

The amount of tax revenue collected varies hugely across countries and is not related to the level of economic growth. While tax revenues averaged 33.5% of GDP in OECD countries in 2020, they ranged from 17.9% in Mexico to 46.5% in Denmark.[20]

Tax-to-GDP ratios, 2019 and 2020p (% of GDP)

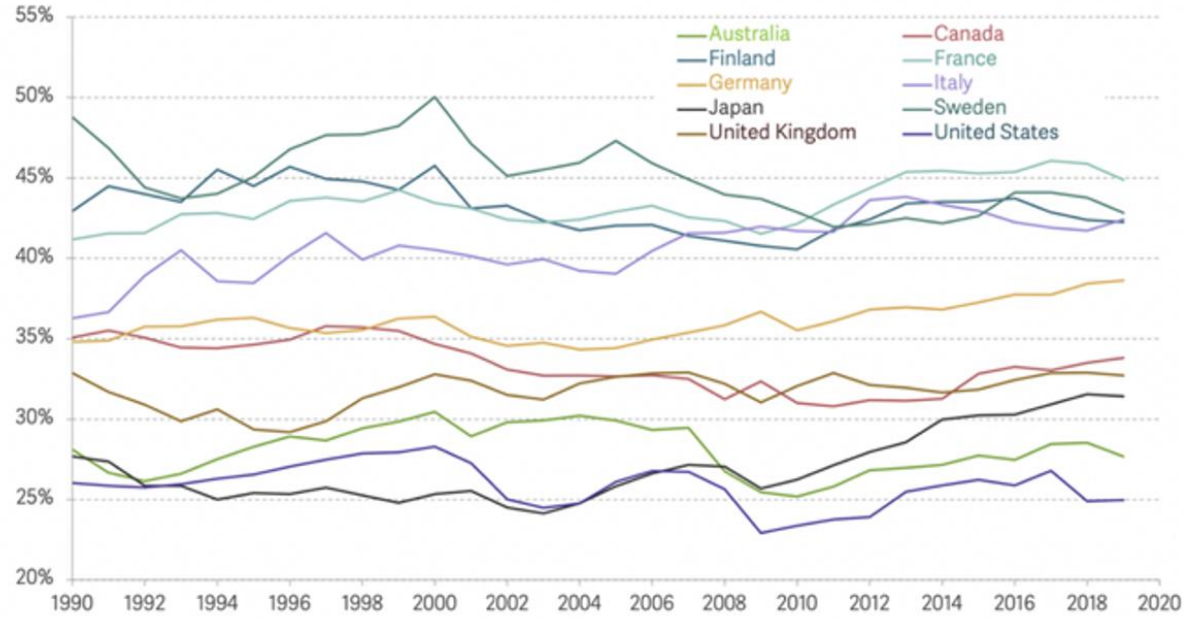


Source: https://www.oecd.org/tax/tax-policy/revenue-statistics-highlights-brochure.pdf

The UK sat just below the OECD average at 32.8% in 2020 (OECD, 2021b). UK tax revenues have typically been higher than those of most other English-speaking developed countries such as the US, Australia, New Zealand and Ireland in recent decades, but significantly lower than most other western European countries.

[20] The tax-to-GDP ratio gives an indication of the scale of revenues in the context of the economy from which they are generated. For discussion and cross-country data on other types of measures, such as the tax-to-GNI ratio, tax per capita, tax revenue as a percentage of total revenue, and tax revenue as a percentage of total government expenditure, see OECD 2017.

Total tax revenues as a proportion of GDP, by nation: 1990-2019



Source: Shah et al., 2022

Like other European countries, the UK's tax take has risen steadily since the 1990s, reaching its highest level in 30 years just before the Covid pandemic. In February 2022, planned changes to Income Tax, NICs and Corporation Tax over 2022 and 2023 were projected to increase revenues from 33% of GDP in 2021/22 to 36% by 2026/27, the highest rate since the Second World War (Shah, et al, 2022).[21]

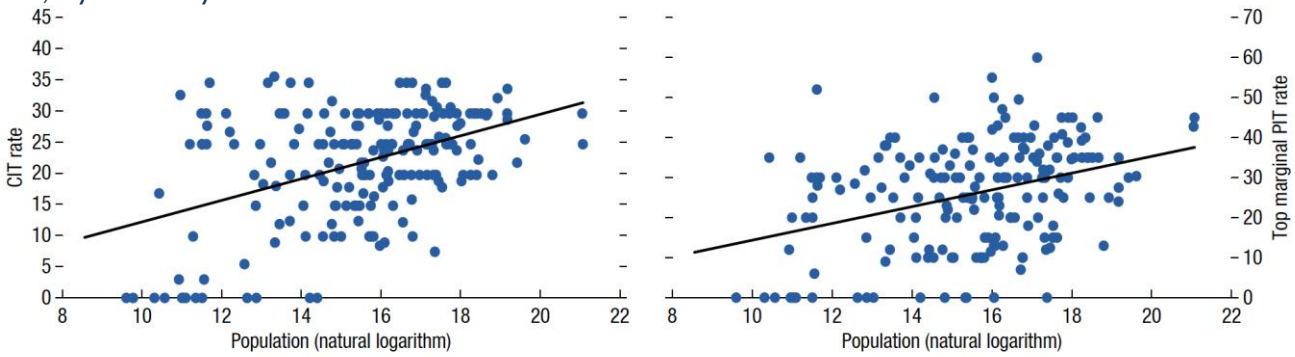
Despite this, however, the UK still has a relatively low tax environment by international standards. Indeed, in 2018 the International Monetary Fund (IMF) argued that the UK Government could increase tax revenues by 5 percentage points relative to GDP and still remain in line with the average for advanced economies (IMF, 2018).

Rates and thresholds

In general, larger countries tend to have higher tax rates than smaller countries. The cost of lowering tax rates is usually higher for larger economies because they tend to have a larger domestic and relatively immobile tax base. Smaller countries tend to have lower tax rates, in order to attract more international investment, corporate profits and wealth (IMF, 2022b).

[21] Note that this does not include changes since announced in the UK Government's Spring Statement.

National Corporate Income Tax Rate, by Country Size; National Personal Income Tax Rate, by Country Size



Source: IMF staff calculations.
Note: CIT (PIT) denotes the statutory corporate (top marginal personal) income tax rate, obtained from the IMF Fiscal Affairs Department Tax Database. CIT = corporate income tax; PIT = personal income tax.

Source: IMF, 2022b

Equally important for revenue raising, as well as fairness and other potential goals, however, are the *thresholds* at which these rates are applied.

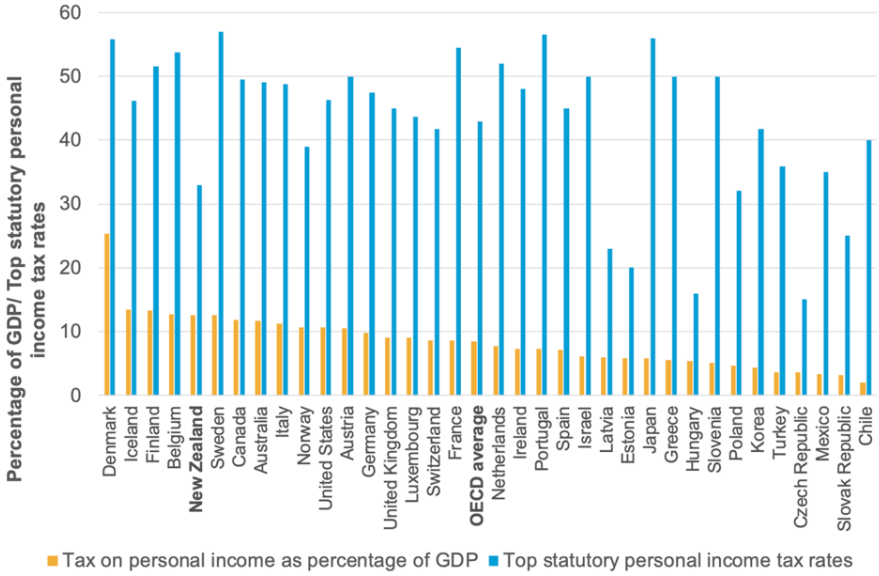
The UK's top statutory personal income tax rate of 45%, for example, might appear relatively high but is only applied to income over £150,000 – 3.6 times the UK average wage in 2020.[22] The Scottish Government has retained this threshold despite Scotland's flatter income distribution – in 2017/18, only 0.6% of Scottish taxpayers paid the top income tax rate compared to 1.1% in the rest of the UK. This meant that 'top' earners contributed only 16% of non-savings, non-dividend Income Tax in Scotland compared to 30% in the rest of the UK, making Scotland particularly reliant on basic rate taxpayers (Deerin and Payne, 2019).

By comparison, in 2020, the top statutory rate in Sweden of 52.3% applied to income above 1.1 times its average wage, and the top 55.9% rate in Denmark applied to income above 1.3 times its average wage. The UK's higher rate of 40% and Scotland's of 41%, which are applied to a more comparable portion of the population, were low by comparison. Conversely, while countries like New Zealand had a much lower top rate of 33%, they also applied this to a much broader cross section of income earners, those with income above 1.1% of their average wage.[23] In each case, top personal tax rates are applied to middle and upper middle class earners, as well as very high income earners.

Thresholds matter for the degree of progressivity but also because the *composition* of the tax base will determine the revenue that a tax rate will generate – including a relatively lower rate. New Zealand's relatively low top personal tax threshold, together with no personal 'tax free' allowance and relatively few reliefs and exemptions, meant that it collected the 5th *highest* level of revenue as a proportion of GDP even with the 6th *lowest* top personal tax rate in the OECD in 2015. By comparison, the UK collected significantly less revenue despite having a much higher top rate.

[22] https://stats.oecd.org/index.aspx?DataSetCode=TABLE_I1
[23] Ibid.

Taxes on personal income as a percentage of GDP (2015)



Source: NZG 2018

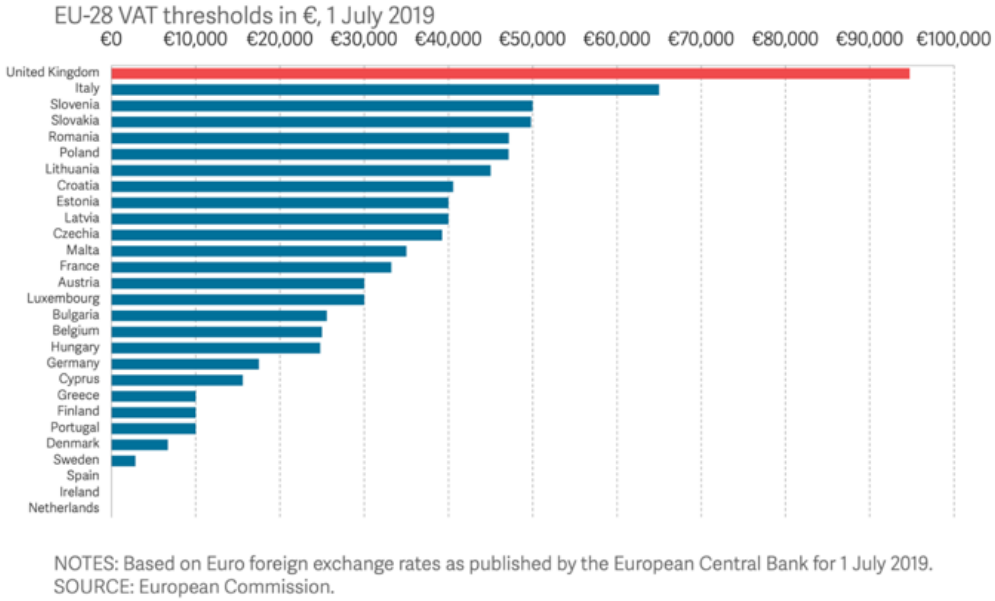
Tax rates and thresholds are therefore not just a matter of progressivity but need to take account of the composition of the tax base. The effect of Scotland's 'flatter' income distribution compared to the wider UK has been compounded by slower average earning growth in Scotland, particularly at the top end of the income distribution (SFC, 2021). The cumulative impact is estimated to have reduced funding to the Scottish Budget by £230 million (SG 2021c).

This illustrates why countries with flatter income distributions, like Scotland, tend to need to apply their higher/top tax rates to middle and upper middle, as well as very top, income earners. This is the direction that the Scottish Government has been moving towards in relation to its 'higher' rate by 'freezing' its threshold[24], but the 'top' rate threshold is still very high relative to some comparator countries.

Conversely, at the bottom end of the tax base, 'tax free' thresholds also have a significant impact on revenues. The UK's VAT threshold provides a stark example. While most countries have a threshold below which small businesses are not required to charge or collect VAT, the UK's threshold of £85,000 (USD 111,000) is the highest in the OECD. By comparison, countries such as Denmark and Finland are amongst those with relatively low thresholds (between USD 5,000 and 30,000) while Norway and Sweden are even lower (below USD 5,000) (OECD, 2020a).

[24] https://www.gov.scot/publications/changes-scottish-income-tax-2022-2023-factsheet/

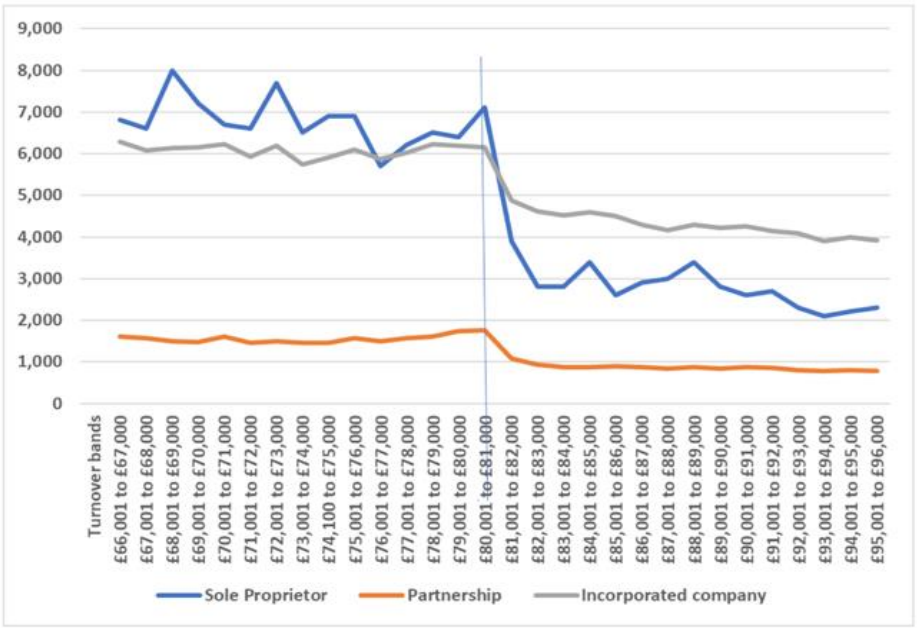
EU-28 VAT thresholds, 1 July 2019



Source: Bangham et al., 2020

While this keeps around 3.55 million small businesses out of VAT in the UK, it also has real-world impacts on the economy and reduces the revenues VAT can raise. While 'bunching' around the VAT registration threshold occurs in all countries, the UK's high rate makes the effect more pronounced, distorting competition between businesses who are required to charge VAT and those that do not and creating a disincentive for a possibly significant number of businesses to increase their productivity and grow.[25]

UK: Numbers of entities by turnover band around the registration threshold



Source: OTS, 2017, drawing on HMRC data from 2014/15 when the threshold was £81,000

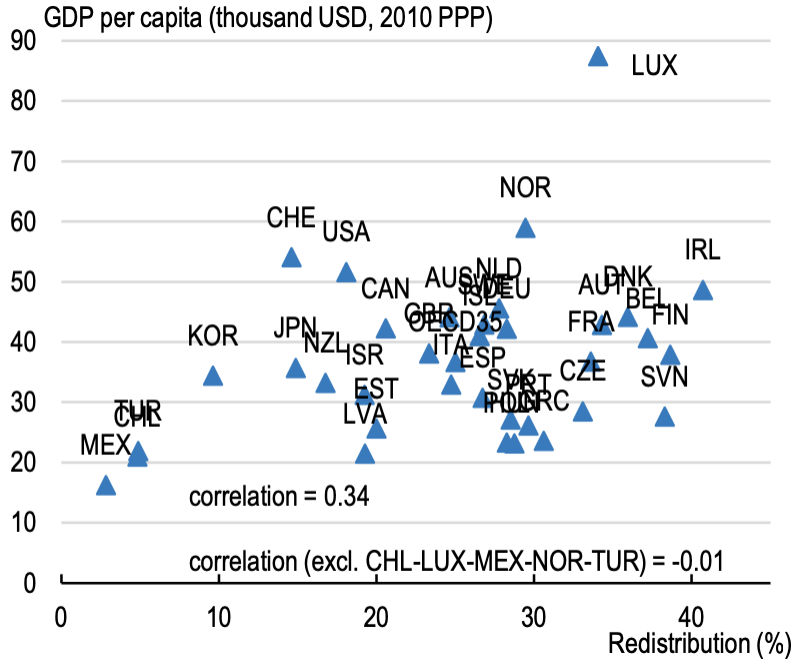
[25] The OTS has recommended that the threshold be lowered, and also explored the pros and cons of other options including smoothing the cash and/or administrative impact of becoming registered or a time-limited reduction for newly-registered businesses (OTS, 2017). While the UK Government has frozen the threshold at £85,000 until April 2022 it has not yet responded to the OTS's recommendation tha this be lowered. See, https://www.gov.uk/government/publications/vat-thresholds-remain-unchanged/vat-maintain-thresholds-for-2-years-from-1-april-2020

The effect on revenues is illustrated by an Office of Tax Simplification (OTS) estimate in 2017 that a reduction in the threshold to £43,000 (for example) would raise between £1 billion and £1.5 billion pa. (OTS, 2017). As always, a 'generous' tax free threshold means that revenues foregone need to be raised through a greater tax contribution from other groups.

Tax, redistribution and economic performance

Despite claims often made to the contrary, there is no inevitably negative relationship between economic performance and the extent of redistribution countries undertake – i.e., an efficiency/equity trade-off. If there is an association, it is very weak, with equally affluent or equally poor countries undertaking very different levels of redistribution.

GDP per capita and redistribution: 2014 or latest available year[26]



Source: Causa and and Hermansen, 2017

Rather, it is the way in which money is raised and spent, along with a much wider set of contextual factors, that will determine economic impacts – either good or bad. Indeed, part of the reason that high growth countries tend to have a larger share of tax revenues as a proportion of GDP is that they are able to invest in policy settings that support economic development such as education or good-quality regulation (Besley and Dunn, 2022).

[26] Data refer to 2012 for Japan; 2015 for Chile, Finland, Israel, Korea, the Netherlands, UK and US; and 2014 for the rest.

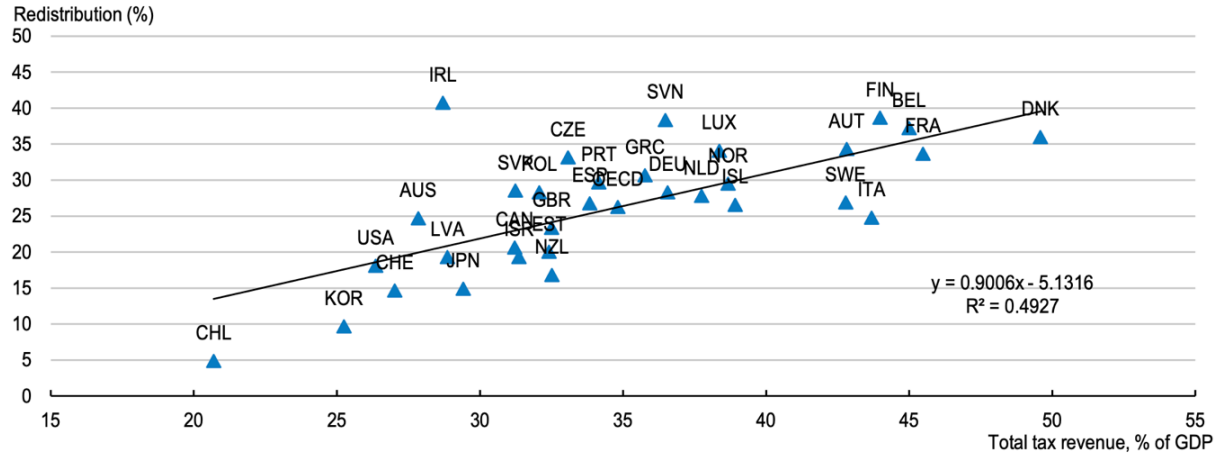
This is the case even for corporate taxes:

> *… an economy's 'competitiveness' and its ability to achieve high and growing productivity and economic prosperity are likely to be driven primarily by domestic factors. If these mean that it is able to generate plentiful investment opportunities with high (pre-tax) returns, then its tax rate (if broadly in line with other similar economies) may not have much effect on levels of investment. In other words, if the competitive pillars of an economy are strong, it is generally more able to impose corporate income tax without discouraging investment. This highlights the importance of governments spending their tax revenues efficiently in areas that strengthen the fundamentals of competitiveness. Conversely, low CIT rates may not be able to compensate for weaknesses in the competitiveness 'pillars'* (Matthews, 2011).

That said, a positive association is also not inevitable. Some of the higher-redistribution countries are also amongst the poorer performers economically.

On the other hand, it is the case that higher tax revenue is broadly associated with the extent of redistribution that countries undertake.

Total tax revenue and redistribution among the working-age population, 2014 or latest available year



Source: Causa and Hermansen, 2017

Again, however, the picture is more nuanced. One of the most redistributive countries, Belgium, spends almost four times more on cash support to the working-age population as a proportion of GDP than Korea, one of the least redistributive countries, despite only raising around double the amount of tax revenue. Italy raises around the same tax revenues as Finland as a proportion of GDP, but achieves only two-thirds the redistribution. Conversely, Italy achieves a similar level of redistribution as Spain despite raising more than 10 percentage points less tax revenue (Causa and Hermansen, 2017).

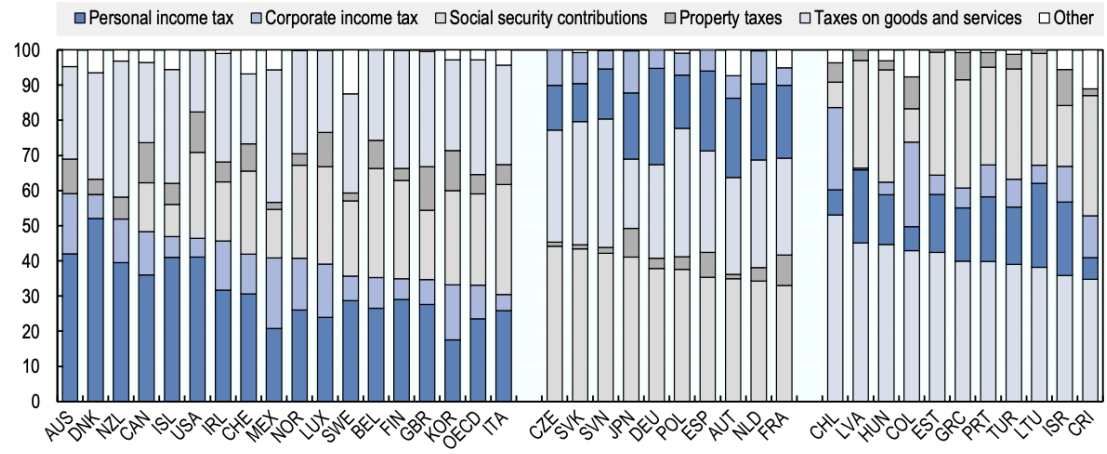
Rather than determining the redistributive impact, the level of revenue tends to be associated with the type of model used to achieve it. Higher tax countries such as the Nordics tend to have less progressive income taxes and greater universalism in social provision; lower tax countries, such as the Anglo-Saxons, tend to have higher levels of

income tax progressivity along with more targeted transfers. The latter can still achieve a reasonable – or in some cases significant – redistributive effect but tend to result in high effective marginal tax rates for lower- and some middle-income households.[27]

Mix of taxes

As well as varying in the level of revenue raised, countries vary in the mix of taxes used to raise it. Broadly speaking, 17 OECD countries raise the largest part of their revenue from income taxes (corporate and personal) and a further ten raise the largest part from social security contributions, while the remaining eleven rely most heavily on consumption taxes.

Tax structures in 2019 (as % of total tax revenue)



Note: Countries are grouped and ranked by those where income tax revenues (personal and corporate) form the highest share of total tax revenues, followed by those where social security contributions, or taxes on goods and services, form the highest share.
Source: Secretariat calculations based on data in chapter 4.

StatLink https://stat.link/h3m41g

Source: OECD, 2021b

The UK is amongst the first group, with three taxes contributing over 60% of all Government tax revenues – Income Tax (26.1% of total tax revenues), VAT (20.3%) and NICs (18.7%) (Tetlow and Marshall, 2019). Indeed, the UK has become increasingly reliant on taxes on income in recent years and, within this, taxes on employment earnings rather than other forms of income. This trend will continue with the introduction of the new Health and Social Care Levy, the bulk of whose revenue will come from workers, despite its extension to those over state pension age and to income from dividends (Johnson et al., 2021).

To date, environmental taxes have made a relatively small contribution to overall tax revenues – accounting for around 5.1% of total tax revenues in OECD countries, on a weighted average basis, and ranging from 2.8% (USA) to 12.5% (Slovenia, Turkey),

[27] It is important to note that these and most other international comparisons do not build in the redistributive effect of public services such as education, health and care services. Across OECD countries, these reduce income inequality by almost as much, or sometimes more than targeted cash transfers – and the UK's public services again tend to have a greater redistributive impact than in many OECD countries due to greater targeting to lower income groups.

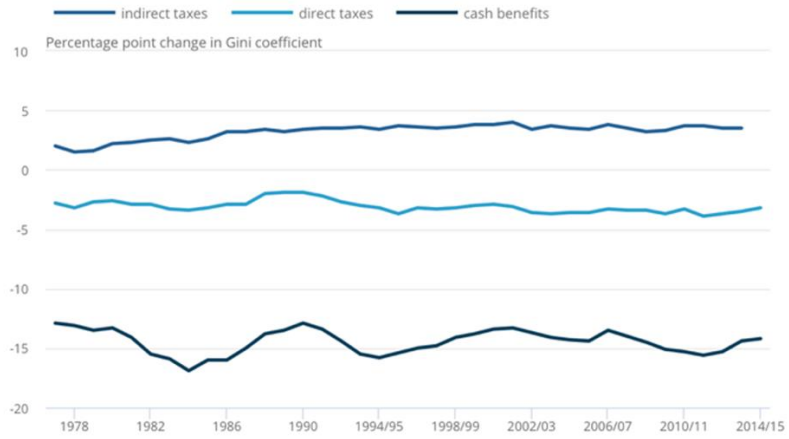
mainly from taxes on energy, mainly road fuels, and transport (OECD, 2019). The longstanding idea that countries might shift from labour to environment taxes to support sustainability objectives has largely not been realised (EEA, 2022).

While income and consumption taxes provide the majority of national government revenues, property taxes provide a large share of revenues at subnational level – over 90% of subnational level revenues in four countries, including the UK (OECD, 2020b).

Combined effect of taxes and transfers

Income Taxes are usually the most progressive part of countries' tax systems, but this progressivity may be offset by the effect of other taxes. In the UK, for example, the progressivity of direct taxes is largely offset by the regressivity of indirect taxes such as VAT, and fuel and alcohol duties, when measured in relation to income.

Change in Gini coefficients because of cash benefits and taxes, 1977 to 2014/15: UK



Source: ONS, 2016

Similarly, while the proportion of income paid in direct taxes in Scotland (Income Tax, employees' NICs and Council Tax) increases with income, broadly speaking, the incomes of individuals in the bottom quintile are reduced by indirect taxes to a much greater extent than other income groups, resulting in a roughly proportionate distribution overall (except for the bottom quintile who pay more and second quintile who pay less).

Taxes as a percentage of gross income for all individuals by quintile groups, Scotland, 2018/19

Percentage of gross income	**Bottom quintile**	**2nd quintile**	**3rd quintile**	**4th quintile**	**Top quintile**	**All individuals**
Direct taxes[28]	7.3	13.3	17.9	20.7	27.5	21.6
Indirect taxes[29]	31.1	17.8	17.1	13.7	9.4	13.9
ALL TAXES	38.4	31.1	35.0	34.4	36.9	35.5

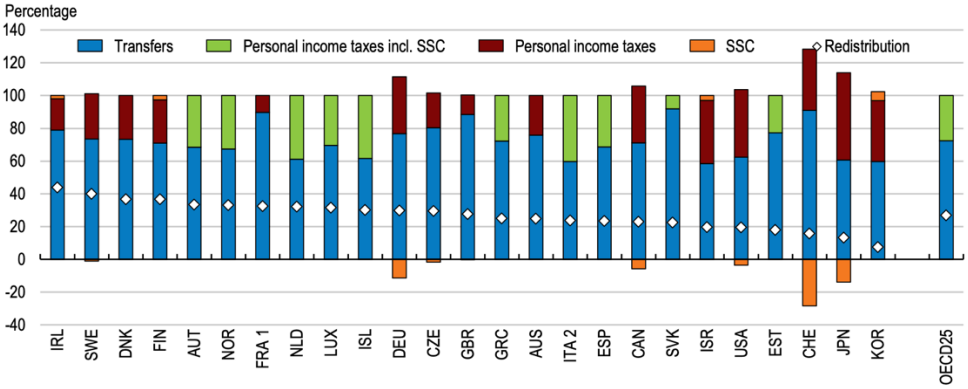
Source: Table constructed using data from ONS

[28] Direct taxes include Income Tax, Employees' National Insurance Contribution and Council Tax.
[29] Indirect taxes include VAT, duties on alcohol, tobacco and hydrocarbon oils, vehicle excise duty and other indirect taxes.

The overall impact depends on the mix and extent of reliance on different taxes within a country. For example, if income taxes are more progressive than social security contributions or indirect taxes, as is usually the case, then more reliance on income taxes will tend to increase progressivity overall. [30]

While taxation is the focus of this paper, in most countries it is the transfers rather than tax system that does the 'heavy lifting' to reduce income inequality. Only a quarter of fiscal redistribution in OECD countries is achieved through direct taxes, compared to three quarters through direct transfers (IMF, 2021).

Share of total redistribution from transfers and taxes, working-age population



1. Social security contributions not available for France.
2. For Italy taxes and social security contributions are based on imputed values (see LIS documentation).

Note: See Box 4 for the approach to assess the redistributive impact of individual parts of the tax and transfer systems. For some countries only the total amount of personal income taxes and social security contributions are reported, while for others the split is available in LIS. Working-age populations include all households with a household head aged 18-65. Data refer to 2005 for Sweden; 2008 for Japan; 2010 for Australia, Canada, France, Iceland and Ireland; 2012 for Israel and Korea; 2014 for Italy; and 2013 for the rest.

Source: OECD staff calculations based on the Luxembourg Income Study.

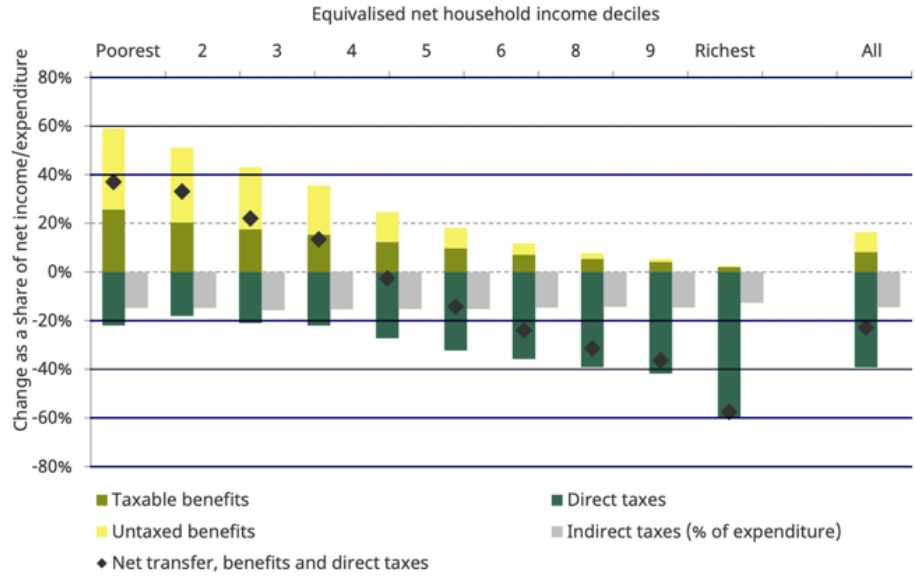
Source: Causa and Hermansen, 2017; data for 2013 or latest available year.

Similarly, while reliance on progressive income taxes plays a part, the bulk of redistribution in the UK is achieved through cash transfers by focusing these on low-income households. Benefits reduce the Gini coefficient (measure of income inequality) by around 13 percentage points while direct taxes only reduce it by around 5 percentage points. Transfers, in other words, redistribute towards low income-earners to a much greater extent than taxes redistribute away from top income-earners (Bourquin and Waters, 2019; see, also, Causa and Hermansen, 2017).[31]

[30] Income Tax progressivity is, however, a design choice rather than a 'given.' Some countries or states have applied 'flat' rather than 'progressive' tax rates to personal income. Hungary, for example, applies a flat tax rate to income, as do many US states. Until very recently, the Czech Republic, Latvia and Lithuania all had flat tax systems, but have moved to progressive income tax rates in the last few years. Similarly, Russia's 'flat' tax of 13% was modified in 2021 to include a new 15% rate for earnings over US$67,000. Estonia also has a flat tax rate of 20% which applies to all income derived by resident taxpayers, with a small number of exceptions.

[31] The difference is also a function of the fact that means-tested benefits are determined by household incomes, and so redistribute towards low-income households, whereas direct taxes only redistribute away from high-income individuals, who may or may not be part of a high-income households (Bourquin and Waters, 2019).

Effects of taxes and benefits by income deciles, 2016-17: UK



Note: Incomes have been measured at the household level but before housing costs have been deducted. The unit of analysis is individuals. Quintiles are based on equivalised (using OECD equivalence scale) net household income, but the income components are not equivalised. All benefits and direct taxes are shown as a share of net household income, while indirect taxes are shown as a share of household expenditure.

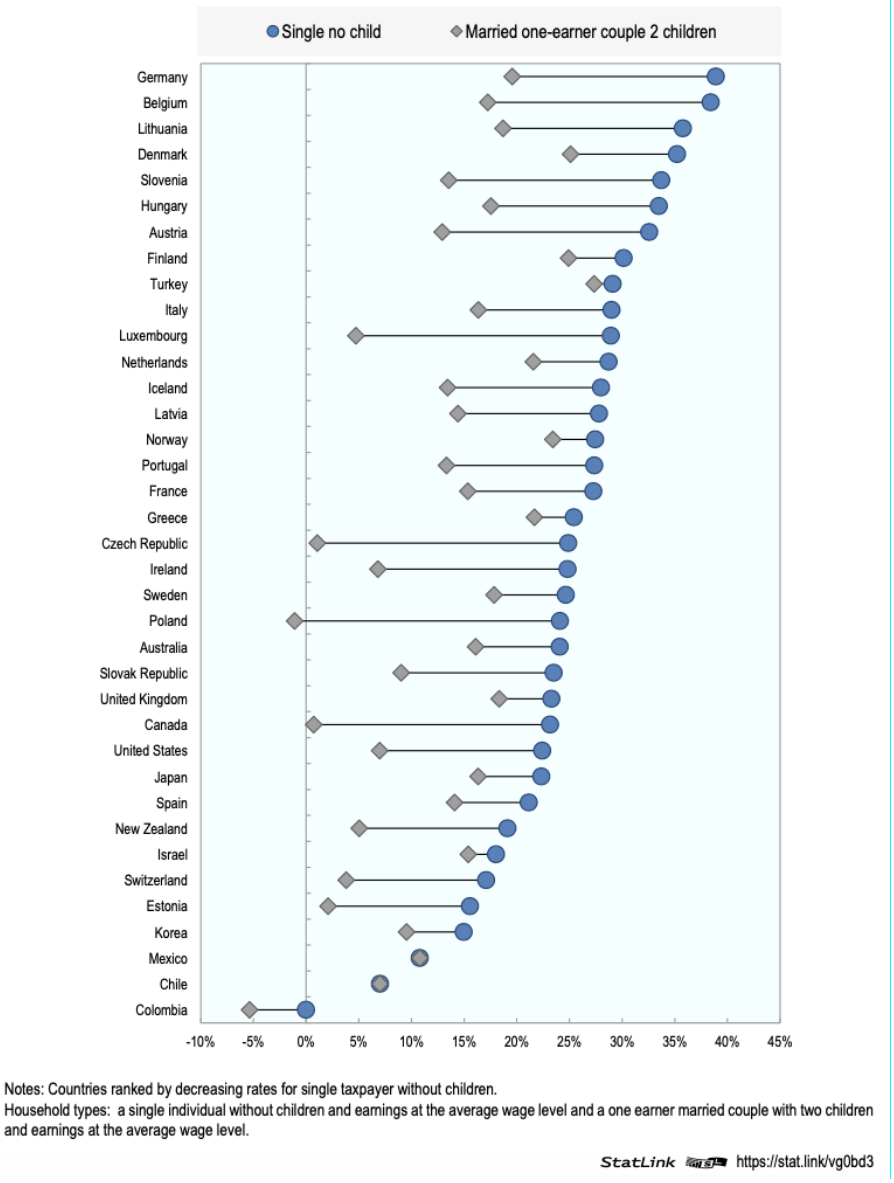
Source: Authors' calculations using the ETB, the FRS and the HBAI, 2016–17.

Source: Bourqin and Waters (2019)

Finally, countries also vary significantly in the types of households they redistribute to via the combined tax and transfers systems. The 'tax wedge', which measures the difference between labour costs to the employer and the net take home pay of the employee, varies significantly across countries – from less than 20% in New Zealand, Czech Republic and Ireland to more than 40% in Austria, Belgium and France in 2015 (OECD 2018a) but also within countries. Some focus their redistribution much more towards families with children than others. Tax reliefs and cash benefits for families with children mean that the disposable income of a one-earner couple with children will be more than 20% of earnings higher than that of a single individual in six countries, whereas the UK is amongst the countries with the smallest difference in tax contribution, at 5 points higher.

Income tax plus employee contributions less cash benefits: 2020.

As % of gross wage earnings, by single and one-earner couple taxpayers



Notes: Countries ranked by decreasing rates for single taxpayer without children.
Household types: a single individual without children and earnings at the average wage level and a one earner married couple with two children and earnings at the average wage level.

StatLink https://stat.link/vg0bd3

Source: OECD, 2021d

This matters because low fertility in the UK, and even lower fertility in Scotland, is the key driver of population decline and ageing. The need to raise revenues as well as support fertility rates suggests that it is individuals and families without children who may need to make the greater additional contribution.

Chapter 3: Shaping tax policy – broad considerations

There's a well-known joke about a tourist in Ireland who asks a farmer for directions to Dublin. The farmer replies: 'Well sir, if I were you, I wouldn't start from here'.

The same could be said of tax policy. The UK tax system is widely recognised to be overly complex, highly distortionary and "ripe for reform" (Bronwyn Maddox, Institute for Government, in Green Alliance, 2020):

> *Different allowances, rates and coverage between the Income Tax and National Insurance (NI) systems drive perverse behaviours; capital gains and inheritance taxes contain large unnecessary reliefs; property taxes impede mobility and, in the case of council tax, have morphed into the worst features of the tax (the Poll Tax) that they were designed to replace*….(Shah et al, 2022).

The UK tax structure taxes working-age people's incomes more heavily than pensioners' incomes. Employees pay higher levels of tax than the self-employed, with single-director companies paying less again – and the recently-announced NICs increase will widen this further.[32] The exemption for capital gains tax on owner-occupied housing, unlike other assets, together with the Inheritance tax threshold, distorts investment and favours (generally older) owner-occupiers over (generally younger) renters. Older people do pay consumption taxes but tend to spend more of their income on necessities – many of which are exempt from the UK's unusually narrow VAT tax base. Tax legislation has not kept up with digital developments.

Changes by the Scottish Government have made devolved taxes more progressive but have also further complicated them with the introduction of more rates and bands (income tax, business rates, LBTT) and several new reliefs in business rates (Adam and Phillips, 2021).

More broadly, if a country was starting with a blank sheet of paper, it would be unlikely to focus on taxing income, and especially income from employment, something that governments want to encourage for both individual and societal wellbeing. Like the UK Government, the Scottish Government has tended to tweak existing taxes rather than look seriously at potential new sources of tax revenue – the power to create new taxes, with the agreement of the UK Government, remains untested.

If the current UK system is not a good starting point, however, the fact that Scotland has a relatively small number of taxes and that administration of the most significant, Income Tax, is undertaken by the UK Government, could be seen as an advantage. The lack of significant infrastructure reduces the constraints that long-standing institutions and legacy systems might otherwise provide. It could therefore be argued that Scotland has more opportunity than most to 'rethink' what a tax system for the 21st century should look like and use this to inform how it uses its devolved tax powers and its priorities for addition fiscal devolution if the opportunity arises in the future.

[32] This is mainly because there is no equivalent of employer NICs levied on the self-employed. The IFS has estimated that, after the announced changes, the combined NICs rate on employment income (including employer NICs) will rise from 22.7% to 24.6% compared to a rise from 9% to 10.25% for the self-employed (Johnson et al., 2021).

Chapter 1 set out the broad objectives most countries take into account in designing or reforming tax systems and made the case that tax revenues will need to increase in the coming years. Chapter 2 looked at how the UK and Scottish tax policy settings and outcomes compare, at a high level, with those of other countries. This chapter discusses some considerations that need to be weighted as Scotland considers how to shape its tax policy for the future.

The primary purpose of tax systems is to raise revenue.

While it might seem an obvious point, it is worth reiterating that the primary purpose of a tax system is to raise revenue to fund Government activities. While tax breaks are often called for to support wider goals, the ability of any Government to achieve its objectives depends first and foremost on its fiscal position. The European Environment Agency (EEA), for example, argues that the *solvency* of the public sector will be critical for addressing climate change and biodiversity loss:

> *"… if governments are not able to allocate financial resources to public investments, which are unconditionally required for the transition process…. They will fail in their primary policy objectives"* (EEA, 2022)

Tax systems can, and should, do this in ways that are fair, efficient and, where possible, promote wider objectives but other mechanisms will often, or even usually, be more effective at achieving these goals. Using the tax system to do so will also often come at a higher cost than first appears, through adding complexity, encouraging 'special pleading' from interest groups, or producing unintended consequences. In contrast, alternatives to tax as a major source of revenue, at least for a country like the UK and Scotland, are fairly few and far between.

Scotland's devolved context means that the government does not have access to the full suite of regulatory and spending powers 'reserved' to the UK Government. This may create a greater temptation to use the tax system to achieve wider goals, if other mechanisms are not available.

Each case, however, needs to be considered on its merits and relative to the other options that are available (subsidies, cash transfers, loans, debt guarantees, regulation or other policy initiatives). In doing so, however, the full cost of tax measures – their direct cost but also the compliance costs for taxpayers and their effect on tax avoidance – and the impact of the alternative taxes that will be required to replace any lost revenues, needs to be factored into decision making. Tax breaks are effectively a form of government spending and should be subject to the same scrutiny and regular review that are applied to other spending.

Who pays

A key consideration is the question of where the impact of a tax falls, and what that means for equity, efficiency and other outcomes. This may be different from who pays a tax initially.

Corporate Tax, for example, is 'paid' by the owners of incorporated companies but these costs are likely to be passed on to customers (higher prices), workers (lower wages) and owners (shareholders), amongst others. There are a huge range of estimates about how these costs are actually distributed, and limited UK-specific evidence, but studies for the US and Germany, for example, find that labour bears around one third and half the costs, respectively.[33]

This matters because these streams of income are already taxed through the Income Tax system. The progressivity of the tax system will therefore depend not only on the design of income taxes but where the economic cost of other taxes that also tax income will fall.

The distributional impacts of tax settings and tax changes will also be different in the short term and long term. Taxes that reduce overall productivity will impact on the employment and wages available to workers and therefore living standards over time, for example.

The location of taxpaying entities or individuals is also important. *Source-based taxes* such as Corporation Tax are usually applied to non-residents as well as residents. All else being equal, taxes paid by foreign residents should allow locals to pay lower taxes, making them an important source of additional revenue. But this also means that lowering corporate taxes can provide a windfall gain to foreign investors and reduce overall revenues if they tax investments that would take place regardless of the tax rate (e.g., that are location-specific), rather than promote additional investment.

It is the progressivity and efficiency of the tax (and spending) system as a whole that matters.

While public debate often focuses on the degree of progressivity of direct taxes, or specific rates, thresholds or reliefs to be applied, it is the combined effect of all taxes, together with other forms of transfers, that matters for incomes – for individuals and firms – and revenues.

The combination of tax and transfer systems, rather than tax alone, for example, is what influences peoples' decisions to work, or to increase or decrease their hours of work or earnings, and the cost of labour for employers, alongside a host of other factors.

This matters for fairness, because groups differ significantly in the extent to which they change their work decisions in response to financial work incentives. In the UK, women's decisions about both employment and hours of work are quite sensitive to tax and benefit changes, particularly if they have young children, and especially if they are a lone parent. In contrast, tax and benefit settings appear to influence men's decisions about *whether* to undertake paid employment but not their decisions about *how much* work to do – i.e., number of hours (Meghir and Phillips, 2008). If a government wants to reduce income inequalities, this will depend as much – or more

[33] https://ifs.org.uk/uploads/corptax-FSS-2021-FINAL.pdf

– on improving access to employment and higher wages as direct cash transfers or tax breaks. The amount and distribution of employment and wages will, in turn, be a significant determinant of the level of tax revenues that Income and other taxes, such as consumption taxes, raise.

This also means that progressivity and efficiency need to be maximised across the tax (and related) system(s) as a whole, not in relation to each tax individually. While progressivity is desirable, discussion often focuses too narrowly on the degree of progressivity of a single tax. Moreover, efficiency also matters for progressivity because it impacts on the amount of money that can be raised. An efficient tax, even if regressive, can enable a government to raise more revenues that can then be redistributed to achieve greater progressivity overall, or to reduce tax rates which also benefits the poor, or a mix of both. The benefits of a broad base for both Income Tax and Consumption Tax, discussed elsewhere in this paper, demonstrate this point.

The same is true for environmental taxes. As a recent IFS report put it:

> *Not every tax – such as VAT – needs to be 'green' and 'progressive': what matters is that the system as a whole is green and progressive* (Abramovsky et al., 2017).

That said, there is a limit. Fairness and the perception of fairness matters for government legitimacy and for 'tax morale' – the willingness of people to pay tax. If a system is seen as unfair, this will encourage tax avoidance that itself will create inequalities, since compliant taxpayers are effectively paying more to make up for revenues lost. So, it is always a balancing act.

Finally, outcomes will depend not only on what is taxed but also *what is not taxed*. The absence of a tax – for example, the absence of land taxes, the lesser taxation of wealth than income, the relative absence of environmental taxes, or the myriad of reliefs and exemptions throughout income, consumption and other taxes - will impact fairness, economic, environmental and other outcomes as much as, and maybe even more than, the taxes that are levied.

Importance of a clear objective and strategy

There is no single optimal tax design – the art of tax policymaking is to find the optimal balance between competing objectives in a given context. A clear objective for tax design and a strategy for achieving it is, however, essential. Too many objectives almost always result in a complex, muddled and less effective system.

This point bears repeating, given the UK's system is generally recognised to be highly complex, often distortionary, and often unfair. Piecemeal or reactive tax policymaking, particularly where revenues need to be maintained, almost always results in greater complexity (ICAS, 2020). This is a greater risk where a system is already complex, because having lots of tax breaks increases expectations of, and pressure for, more.

That said, if a country has a clear strategy and overall direction, it can undertake significant tax reform or move towards it in stages. This is the lesson of the Nordic

countries that moved to ‘dual rate’ treatment of personal and capital income, raising overall revenues at the same time, or New Zealand, which radically reformed its tax system and then steadily reduced distortionary tax reliefs over a number of decades.

Clarity about the goal and direction of travel, about the reasons why a model is preferred for a given country’s context and objectives, and about what this implies for other related systems (social security, pensions, etc.) is, perhaps, the key challenge, whether a country has full tax powers or, as in Scotland, aspirations for greater tax devolution.

Chapter 4: Selected Design Choices

Most fundamentally, countries have choices about *what* and *how* to tax. On what to tax, this section discusses two core choices: the balance between taxing income from labour and income from capital; and, following on from that, the extent of taxation of wealth itself.

On how to tax, this section considers the arguments for and against one-off ('windfall') vs recurrent taxes; and argues that one of the main opportunities to increase UK and Scottish tax revenues lies with broadening their bases. As well as raising revenues, broadening tax bases would often improve efficiency, increase fairness and, in some cases, reduce subsidies for environmentally harmful practices.

Taxing income - aligned or dual rates[34]

While this paper has argued that a tax system would, ideally, not begin by taxing employment, taxes on income are likely to remain an important part of the UK and Scottish tax systems. It is therefore useful to consider two broad models that countries pursue in taxing income. While no country 'perfectly' applies either, they each provide an ideal that helps to clarify the pros and cons of moving towards, or deviating from, the approach in question.

The first aims to *align* tax rates across labour and capital income for higher income earners, including the corporate income tax rate.

The advantage of aligning the top labour tax rate with the capital income tax rate is that it taxes labour and capital income neutrally, eliminates distortions and removes the incentive for high income earners to use company structures to 'shelter' income in order to pay lower rates of tax. This can, however, mean that capital/corporate tax rates are relatively high, reducing international competitiveness, or limit the extent to which the top personal tax rate can be raised without losing the benefits of alignment.

The second 'splits' the tax rates applying to labour and capital income – a *'dual income'* system. Labour income (e.g., salaries and wages, pensions) is taxed at higher progressive rates while capital income (e.g., interest, capital gains) is taxed at a low and usually 'flat' rate, along with the corporate tax rate.

This model responds to the fact that capital is generally more mobile than labour and enables countries to have higher top personal tax rates, increasing progressivity, but remain internationally competitive and avoid capital flight. Aligning rates across all capital income is economically efficient, eliminating distortions and the scope for activities that exploit differences in tax rates and encouraging capital to flow to its most productive uses. It also encourages the reinvestment of profits over payment of dividends.

[34] The following is drawn from OECD (2010a, 2010b), NZIRD (2010; 2022) and Sorensen (2010) unless otherwise stated; with thanks, also, to Peter Wilson for his helpful insights.

The 'split' rate model can, however, raise equity issues, both horizontal (taxpayers with different mixes of capital and labour income are taxed differently) and vertical (since income from capital tends to be concentrated in the upper income brackets but is taxed at a lower flat rate) (OECD, 2010b). Taxing capital gains to a lesser extent than labour income means that workers are, in effect, subsidising the activities of the industries generating those gains (NZG, 2019). It is also potentially complex and difficult to administer, requiring businesses to separate their income into its capital and labour components, and tax administration to have robust systems to avoid income-shifting from labour to capital.

New Zealand reformed its system towards the first approach. It generally applies progressive tax rates to all personal income and a flat tax rate to corporate income but aims to keep the corporate rate as close as possible to the top personal income tax rate – until recently, within 5 points of each other (33% and 28%, respectively), resulting in the fifth lowest 'gap' out of 37 OECD countries.[35] By comparison, the UK's 19% company tax rate and 45% top marginal tax rate created a 26-point gap, which will only reduce to 20 points with the planned Corporate Tax increase to 25% in 2023.[36] On the other hand, the need to keep the corporate tax broadly aligned with the top personal tax rate means that New Zealand's corporate tax rate is the 8th highest in the OECD.

This enables New Zealand to raise fairly high levels of revenue while maintaining lower personal tax rates – as illustrated previously, collecting the 5th *highest* level of revenue as a proportion of GDP even with the 6th *lowest* top personal tax rate in the OECD in 2015 (page 17).

A number of Nordic countries have spearheaded the 'dual rate' approach, with relatively high top personal tax rates and lower corporate tax rates: Sweden's top personal income tax rate was 52% compared to a corporate income tax rate of 20.6% in 2020; Denmark's was 55.9% compared to 22%; and Norway's top personal tax rate was 38.2% while corporate income was taxed at 22%.[37]

These countries are able to raise higher levels of revenue while keeping capital income tax rates at relatively 'competitive' levels. In 2020, Denmark's tax-to-GDP ratio was the highest in the OECD at 46.5%, while the ratios for Sweden, Finland, Norway and Iceland were 42.6%, 41.9%, 38.6% and 36.1% respectively; by comparison, New Zealand only collected 32.2% of GDP in taxes and the UK 32.8% (OECD, 2021b).

While the dual rate system involves lowering capital and corporate tax rates, this is offset by a very broad capital tax base – ideally including interest, dividends, capital

[35] A recent increase in the top personal income tax rate to 39% widened this gap, but still placed New Zealand behind only six other OECD countries in 2020, NZIRD (2022). Even so, the New Zealand tax department has been reported as having to take extra steps to prevent high-income earners using incorporated structures to 'shelter' their income as a result of this increased gap, see https://www.stuff.co.nz/business/128076279/inland-revenue-to-make-it-harder-for-wealthy-to-sidestep-39-per-cent-top-tax-rate

[36] It is worth noting that some countries achieve greater alignment by not having a progressive income tax. Estonia, for example, has a flat 20% tax on individual income (except for personal dividend income), a 20% tax rate on corporate income (distributive profits only) and a property tax on the value of land only, see https://taxfoundation.org/publications/international-tax-competitiveness-index/#Estonia

[37] Oil and gas companies operating within the Norwegian jurisdiction are, however, subject to a special tax of 56% in addition to the general corporate tax of 22%, see https://www.norskpetroleum.no/en/economy/petroleum-tax

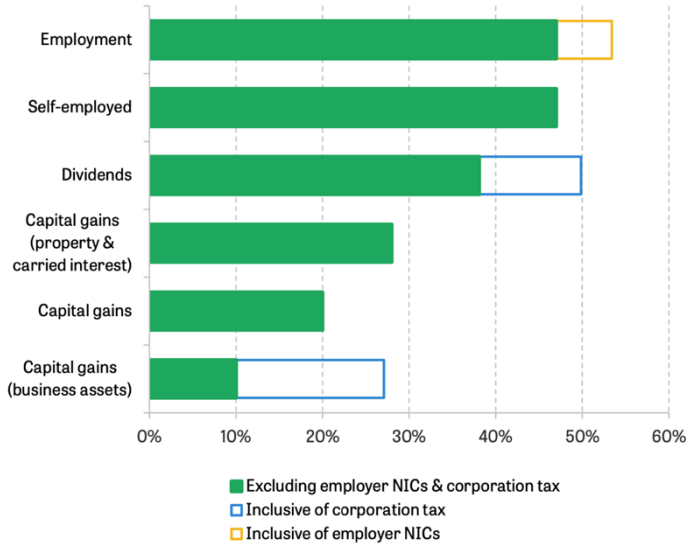
gains, rental income, royalties, imputed returns on owner-occupied housing and on capital invested in non-corporate firms. Indeed, when Norway and Sweden introduced the model, there was a significant revenue gain despite the reduction in capital income tax rates that, in turn, enabled these countries to lower their tax rates on labour income (Sørenson, 2010). The broad capital income tax base contrasts with countries where assets like owner-occupied housing and retirement savings are tax favoured, as in the UK. If many people put the bulk of their savings into these assets, as in the UK and Scotland, then even a higher tax rate on other forms of capital income may not raise significant additional revenues.

Wider policy settings will also interact with these tax settings, and the incentives they do – or don't – create. While capital income is taxed at a much lower rate than labour income, contributory aged pensions are based on labour income in a number of Nordic countries, for example, so there is a countervailing incentive for the self-employed to declare income as labour income. The choice also depends on a country's characteristics – for example, the extent to which high top personal tax rates will encourage out-migration – and the extent to which a country wants to tax residents and non-residents – since corporate taxes provide a final tax on non-residents, unlike income taxes tied to residence.

How does the UK compare?

The UK does not fit either of these models. It applies lower rates to capital income than to labour income but does not align rates across different kinds of capital income. Tax treatment of employment income varies between employed and self-employed people, due to employer NICs applying to the former and not the latter, and depending on the 'form' in which it is paid.

Top marginal statutory tax rates, 2021-22[38]



Source: IFS; Delestre et al., 2022.

[38] "Hollow bars show rates inclusive of employer NICs (in yellow) in the case of employment income, and corporation tax (in blue) in the case of capital gains tax and income tax on dividends. 'Capital gains (business assets)' refers to business assets disposal (BAD) relief, which can be claimed on gains made on the disposal of company stock so long as an individual holds at

The end result is that people with the same level of income but in different legal structures or with income from different sources – for example, employment, interest, dividends, rents, capital gains – face very different tax rates. Incomes of £1 million or more, for example, attract an average income tax of 40% but the average rate is less than 15% if the income is taken as capital gains (Bangham et al., 2020). This creates huge incentives to shift income from labour to capital gain and other forms of business income, and to incorporate. Varying rates for different kinds of capital income is also inefficient, skewing investment choices towards less productive but lower taxed options. They also means that increases in top income tax rate in the UK or Scotland will produce less revenue than they otherwise would, due to the opportunities available for avoidance.

Implications

The contrast of aligned and dual rate models illustrates a key design choice for tax policy. While each model has pros and cons, it is not necessarily better to end up somewhere in between. As the IFS has commented, setting tax rates to compromise between the goals of applying the same rates to labour and business income, and encouraging business, savings and investment means that, in the UK, "neither aim is achieved." [39]

The current devolved settlement, whereby Income Tax on earnings is devolved to Scotland, but not NICs on earnings, means that divergence between Scottish rates and thresholds and those of the UK for either Income Tax or NICs creates additional misalignment. For example, Scottish taxpayers earning between the Scottish higher rate thresholds of £43,662 and the UK higher rate threshold of £50,270 pay 41% income tax and 13.25% NIC on their earnings, a combined rate of 54.25%, compared to 44.25% for those earning above £50,270, due to the fact that the NIC rate set by the UK drops by 3.25% at the UK rather than Scottish higher rate threshold.[40]

The separation of tax on employment from tax on other forms of income (savings, dividends) adds to the potential for unintended distortions, particularly as Scottish thresholds for tax on employment income diverge from UK thresholds for income on savings and dividends, or vice versa. Separation of tax policy related to employment income from decisions on the tax treatment of capital income, including capital gains, prevents greater coherence across different forms of income, should this be a goal.

For Scotland in considering what new taxes it could raise, or the combination of further tax powers it would prefer to devolve, a key consideration, therefore, would be the extent to which it would want to align, or apply different treatment to, different types

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least a 5% stake in the company and is either an employee or an officer of the company. BAD relief has a lifetime limit of £1 million. Capital gains from primary residences are tax exempt. Capital gains from carried interest are taxed at the same rate as gains on property. From 5 April 2022, the rates of employee, self-employed and employer NICs and dividend tax will increase by 1.25 percentage points" (Delestre et al., 2022).

[39] https://ifs.org.uk/taxlab/taxlab-key-questions/should-income-business-be-taxed-income-employment

[40] As discussed by Holyrood's Finance and Public Administration Committee in January 2022 (Scottish Parliament, 2022).

of income, and the implications of this for revenue-raising – whether those revenues are spent or used to reduce tax rates, or a mix of the two.

Taxing wealth

The range of potential taxes on wealth include taxes on total (net) wealth, capital gains, inheritance, gifts, land or other types of assets. This section focuses on the direct taxation of wealth (assets) and the income generated by wealth (capital gains), rather than taxes on *transfers* of wealth (inheritance, gifts) or the *spending* of wealth (consumption taxes such as VAT).

Growing case for increased wealth taxation

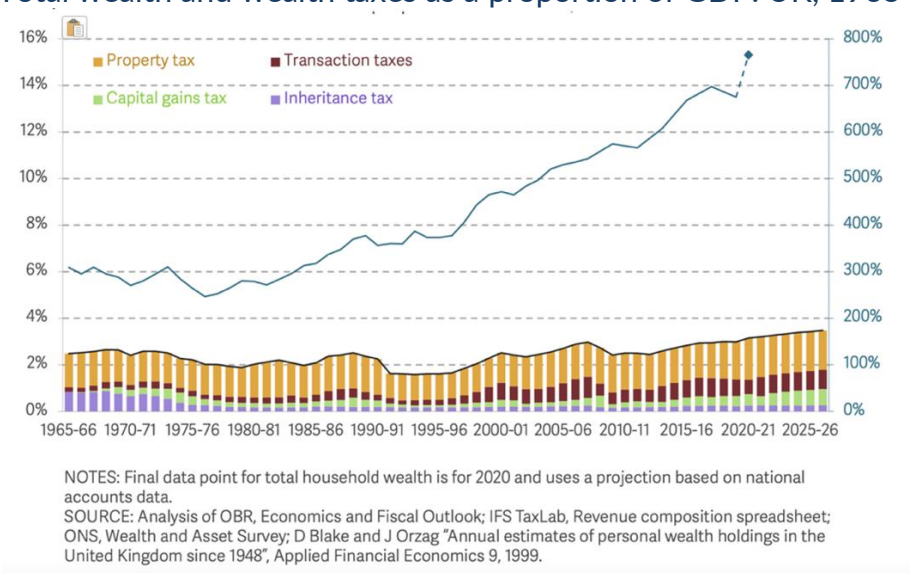
There has been renewed interest in wealth taxation internationally, particularly following the GFC, and, more recently, the Covid pandemic. The case for wealth taxation has been strengthened by the work of Thomas Picketty and others which has drawn attention to the fact that returns on capital have usually outpaced the rate of economic growth over the long-run. This means that, without government intervention, the owners of wealth will steadily get richer than ordinary income-earners (IMF, 2021; EEA, 2022).

In the UK, the level of wealth has increased in recent decades from around three times UK national income in the 1970s to more than seven times in 2020. Scottish wealth grew from five times GDP to more than seven times GDP in the decade through to 2015. The Resolution Foundation has shown that overall wealth inequalities in the UK have not grown significantly since the relative 'lows' of the 1970s and 1980s, but the growth in the size of wealth means that wealth gaps are bigger, making them more difficult to bridge, and particularly as the growth in wealth has outpaced growth in wages. Moreover, generational wealth divides have grown significantly (Bell and D'Arcy, 2018).

The main driver of increased wealth in the UK and Scotland has been the growth in the price of assets. Returns on financial assets and rental property have been heavily skewed towards the top of the income distribution – the top 10% of families by wealth in the UK received 60% of all financial investment income and 32% of all rental income in 2016-18 (Bangham and Leslie, 2020). Capital gains on housing, particularly for owner occupiers, have been one of the most significant drivers, with gains mainly flowing to those who already hold wealth in housing, particularly older generations. Home ownership is also one of the main drivers of the UK's very significant racial wealth gap (Kanabar, 2022). Inheritances have and continue to provide a significant source of wealth. By definition, much of this constitutes a "passive" accumulation of wealth rather than "active" wealth creation.

The growth of wealth has not been accompanied by increases tax revenues. Indeed, the amount of tax collected has remained almost flat, below 4% of GDP.

Total wealth and wealth taxes as a proportion of GDP: UK, 1965-66 to 2026-27



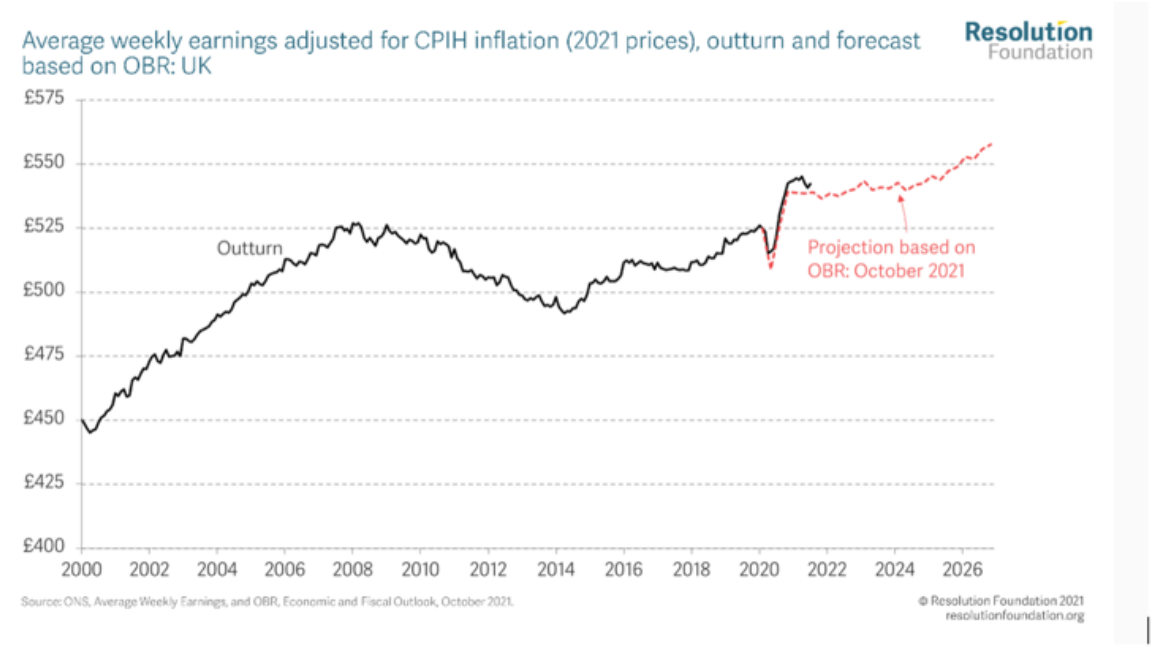
Source: Shah et al., 2022

Inheritance tax, for example, has not kept up with the growth of wealth transfers: between 2006/07 and 2022/23, receipts were forecast to grow less than a quarter as fast as inheritances themselves (Corlett, 2018). UK Inheritance Tax only applies to 4 per cent of estates with an effective tax rate of 3.5%. The Resolution Foundation has estimated that a person could inherit £1 million from their parents and pay no tax while someone working 40 hours a week on the National Living Wage from age 18 to 70 would only earn £753,000 in their lifetime and pay almost £100,000 in tax (Corlett, 2018). Even for those who do pay Inheritance Tax, reliefs that can be exploited by the very wealthy mean that the average effective rate paid by estates worth over £9 million is significantly lower than that paid by estates worth between £2 million and £9 million (Bangham et al., 2020).

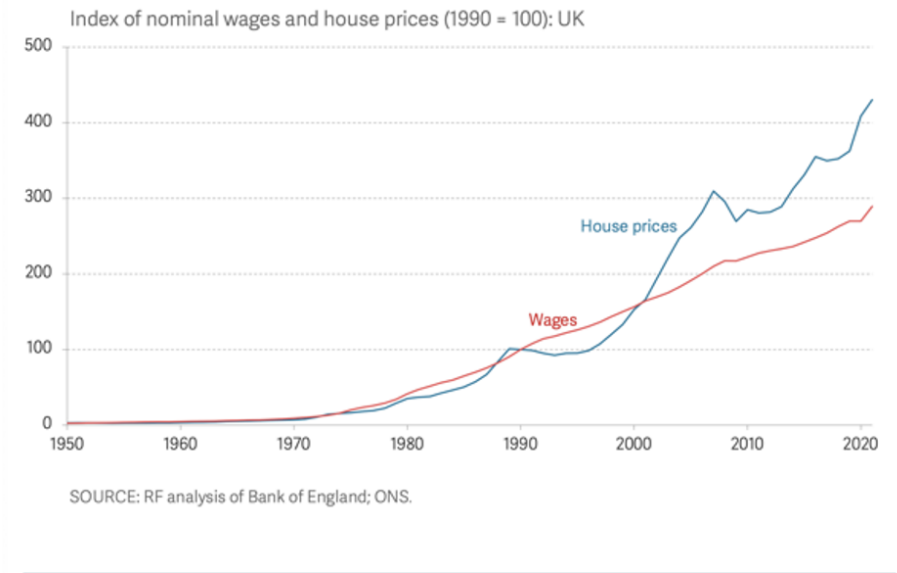
Similarly, despite comprising 80% of households' total net wealth and a significant determinant of wealth inequalities, land and property are particularly lightly taxed in both the UK and Scotland. In the UK, 50% of wealth is tied up in land and property, but it only forms around 10% of the total tax base (Miller, 2019). In Scotland, only around 12% of total revenues raised (reserved and devolved) are raised on taxes fully or partially levied on land and property (Scottish Land Commission website).[41]

The result is that more of the cost of funding the UK and Scotland's ageing population, and other financial pressures, are having to be covered by other taxes, particularly on earnings. This is despite wage growth largely stagnating in recent years and only returning to 2008 levels just prior to the pandemic and projected to grow more slowly than inflation; and the fact that the growth in house prices has also outpaced wage growth over the last 20 years, a significant departure from previous experience.

[41] https://www.landcommission.gov.scot/our-work/tax-fiscal



Wages and house prices: 1990-2020



Source: Corlett and Leslie, Resolution Foundation, 2021

More effective and comprehensive taxation of wealth can be argued for on a number of grounds. Wealth inequality is higher than income inequality – nearly twice as high in Scotland (Bell and D'Arcy, 2018) – and operates in a "self-reinforcing way," with higher income earners having greater capacity to save and invest, and able to generate higher returns on their investments (OECD, 2018c). In the UK, the top wealth decile received an average annual return of more than 2% pa on their financial assets between 2016 and 2018, more than four times higher than those in the lowest three wealth deciles due to differences in portfolio composition alone (Bangham and Leslie, 2020). In the absence of sufficiently comprehensive wealth taxation, the concentration of wealth and wealth inequalities are likely to increase.

Wealth is also relatively economically efficient to tax, depending on design. Under capital income taxation, people who are more productive and generate more income

pay higher taxes, whereas under wealth taxation, people with similar wealth levels pay similar taxes regardless of their productivity, shifting the tax burden towards unproductive businesses and raising the savings rate of productive ones. Wealth taxes that only tax accumulated economic rents – i.e., the amount earned over and above what is required for the investment to take place – are a particularly efficient source of taxation, and even more so when they are earned by non-residents.

Greater taxation of wealth can also be argued for on environmental grounds. Wealth is negatively associated with environmental impact: the richest 1% in the UK have a carbon footprint six times that of the national average, and each produces 11 times the amount of carbon emissions of someone in the poorest 50% of the population. Those in the wealthiest 10% (with income after tax of at least £41,000 pa), have a carbon footprint that is more than double the national average and four times that of someone in the poorest 50%.[42]

Broad wealth taxes, rather than further taxes on income, are also favoured by the British public. Work on public attitudes for the UK Wealth Commission "showed a clear preference for any tax increases to fall on wealth rather than income…. (and) A wealth tax – rather than some other tax on wealth – was the most popular suggestion." Two recent UK studies found high levels of support (61% and 63%) for an annual wealth tax on assets (above a threshold of £750k and £2 million respectively and with main homes and pensions excluded). Support for a comprehensive wealth tax that includes all assets over a £1 million value with no exclusions was the most favoured tax increase option in a 2020 nationally representative survey, almost twice the level of support for increasing Council Tax on properties over £1 million or increasing income tax or VAT (Advani et al., 2020). By contrast, Inheritance Tax is extremely unpopular, with only 22% of people seeing it as "fair" (Corlett, 2018).

In the UK and Scotland there is now a strong case for greater taxation of wealth as a way of raising revenues that would also help address issues of equity, both across the population and intergenerationally, and be relatively economically efficient compared to other tax options.

Current UK wealth taxation

The UK's wealth-related taxes are mainly tied to the returns on wealth (income tax, capital gains tax) or transfers of wealth (inheritance, gifts), or particular classes of asset such as property (Council Tax). They have well-recognised problems and been described as "a mess":

> *The UK's current approach to taxing wealth lacks a clear set of objectives. The legislation is complex; anti-avoidance rules have often been used to patch systemic incoherence. There are large distortions, especially across different asset classes, for not good reasons. Existing taxes – most of all inheritance tax (IHT) – are unpopular, partly driven by a perception (which has some basis in reality) that the wealthiest do not pay* (Summers, 2021).

[42] Oxfam estimates, December 2020, see: http://oxfamapps.org/media/96h9d. Note that while these estimates use income as a proxy for 'wealth', in practice these are closely correlated.

As discussed above, the UK applies very different rates to labour and capital income, and capital gains are particularly lightly taxed. This exacerbates intergenerational inequities with older generations having amassed much more housing and pension wealth, which attract zero or reduced tax rates, while younger people have less wealth and get more of their income from wages, which have stagnated since the GFC and are more highly taxed, impacting on relative living standards. Inequalities within the millennial group are set to be further concentrated through inheritances: already-wealthy millennials are due to inherit more than four times as much as those with no property wealth (IWC, 2018; Miller, 2019).

Despite numerous proposals for reform over many years, little progress has been made. The contrast between the treatment of wealth and employment income particularly at a time of escalating cost-of-living pressure has, however, heightened calls for a change:

> *… continuing to increase taxes on earnings but not other forms of income is indefensible. Doing so amidst a prolonged, and rapidly worsening, pay squeeze, while tax revenues from wealth-related taxes have remained largely stable as a proportion of GDP even as the value of household wealth has grown from three times to nearly eight times GDP, is an approach that has run out of road* (Shah et al., 2022).

As the Resolution Foundation has argued, a rethink of the current UK model whereby capital is taxed more lightly than employment income, and some forms of capital gains, particularly from owner-occupied housing, are "entirely untaxed" is clearly needed (Corlett and Leslie, 2021). In addition, there is widespread support for a more direct relationship between the amount of wealth that an individual *owns* and the amount of tax that they pay (Summers, 2021).

International developments

The rising scale, increasing concentration and 'unearned' nature of wealth accumulation has fueled arguments for greater wealth taxation internationally, with the OECD concluding that there is a "strong case for greater wealth taxation" as a way of addressing wealth inequality (OECD, 2018c).

A number of countries, including some who had previously moved away from wealth taxation, have reintroduced or increased wealth taxes. Norway's 2022 budget increased the wealth tax rate and changed tax brackets for both income and wealth taxes, generally increasing the amount paid by those with high income and wealth;[43] Denmark is proposing that its richest 1% pay more on dividends and capital gains from shares;[44] and Finland's government has announced the introduction of an exit-tax on the capital gains accumulated by affluent emigrants from 2023.[45]

[43] See https://home.kpmg/xx/en/home/insights/2021/12/flash-alert-2021-317.html
[44] See https://news.bloombergtax.com/daily-tax-report-international/denmark-wants-to-raise-tax-on-top-1-to-fund-labor-shortage-fix; https://www.bloomberg.com/news/articles/2021-10-04/tax-the-rich-era-in-nordic-region-is-showing-signs-of-a-comeback
[45] See https://www.borenius.com/2021/09/13/new-tax-decisions-introduced-in-the-latest-government-budget-session/

That said, wealth taxes can be politically challenging. Iceland's Social Democrats suffered heavy losses in the 2021 Icelandic election running on a platform that included wealth taxation proposals.[46] The New Zealand Government recently commissioned analysis of the amount of tax paid by the wealthiest but has been at pains to stress that it has "no secret plan" to introduce new wealth taxes at this time.[47]

Taxing the ownership of wealth

Most countries levy capital income including capital gains taxes of some kind. They then have a choice about whether, and to what extent, to tax the *ownership* of wealth itself.

There are strong fairness arguments in favour of wealth taxation in addition to taxation of capital gains and capital income. Capital income taxes alone will not reduce wealth inequalities, or avert their growth, because of the higher levels of investment and higher returns the already-wealthy are able to generate. As the OECD has concluded, if reducing wealth inequalities is a goal, capital income taxes need to be accompanied by taxation of wealth itself (OECD, 2018c).

Net wealth taxes are the most comprehensive form of wealth tax. These are levied on all categories of wealth, with all (or most) types of assets included and treated equally, giving them a very broad base.[48] Their comprehensiveness means that they are likely to be fairer than taxes on specific types of assets or capital income – the inclusion of all assets, not just property or financial assets or the income from assets, is usually a better indicator of taxpayers' ability to pay than a single asset class alone. Unlike capital gains taxes, they tax the *increase in asset values* each year, usually based on a presumptive return, and are therefore based on current wealth and the benefits it provides even if these have not been 'realized' as income. Taxing total wealth is likely to be more progressive than taxing property alone given the concentration of financial assets at the top of the wealth distribution. In addition, the Norwegian experience suggests that wealth taxes can reduce labour income inequality and so may also increase the likelihood of intergenerational mobility (IMF, 2021).

Net wealth taxes are also relatively economically efficient. Treating all assets equally avoids distortions and can encourage taxpayers to use assets more productively – a wealth tax would tax land that is not being used and does not generate income, for example, whereas a capital income tax would not. By being levied on an accrual basis they avoid lock-in effects – where investors have an incentive to defer sale of an asset for as long as possible – and resulting inefficiencies in capital allocation.

Net wealth taxes have potential to raise significant sums of revenue. The UK Wealth Commission, for example, concluded that a one-off wealth tax could raise £250 billion over five years – the same amount that would be generated by increasing the basic

[46] Ibid.

[47] See https://www.beehive.govt.nz/speech/shining-light-unfairness-our-tax-system

[48] The OECD defines net wealth taxes as "recurrent taxes on individual net assets." They include recurrent taxes on a wide range of movable and immovable property, usually charged once debt has been deducted. They are typically applied to the worldwide assets of residents, but only the assets of non-residents within the taxing jurisdiction (OECD, 2018c).

rate of income tax from 20p to 29p, or raising all income tax rates by more than 6p, or all VAT rates by 6p. They are also a more stable source of revenue for governments than capital income taxes because they apply if an asset retains some value, not only if it generates capital income (Advani et al., 2020).

The main arguments against net wealth taxes include their potential negative and distortionary effects on capital accumulation including savings and impact on capital or residential mobility. If the tax base is broad, a wealth tax may impact the overall level of savings; if it is narrow (i.e., some categories of assets such as pension savings are exempt or subject to reliefs), a wealth tax will tend to affect the *composition* of savings rather than overall levels. That said, empirical studies have tended to find stronger effects on wealth *reporting* – such as 'bunching' below the tax threshold and other increased avoidance and evasion – than on *real behaviour*. Similarly, while empirical evidence is limited, analysis of the relocation of wealthy residents tends to find that taxpayers respond to wealth taxes more by tax avoidance and evasion than fundamental behaviour change such as moving country (OECD, 2018c).

These responses are highly dependent on policy design – low rates, for example, can mitigate the risk of capital flight – and the interaction of any wealth tax with the rest of the tax system, particularly other taxes on capital and income, and the wider economic context. They also depend on how this combination compares to other countries.

Other criticisms include the fact that wealth taxes require a tax contribution from people with assets that do not generate any income during the year. This can, however, be argued to be fair and the practical issues mitigated through provisions for deferred payment. Perhaps most off-putting for governments are the potentially significant practical difficulties with taxing assets on an accrual basis which requires regular revaluations – more difficult for more mobile and less visible assets such as jewelry or artwork – although the use of 'presumptive return' mechanisms can reduce this (OECD, 2018c).

Currently, only four OECD countries levy a form of general wealth tax – Switzerland, Norway, France and Spain (IMF, 2021). While most common at national level, wealth taxes can also operate at sub-national government level: in Switzerland, cantons set a tax schedule, but municipalities can add their own "multipliers"; in Spain, the central government sets the main structure of the wealth tax but regional governments have some powers to change thresholds, rates and tax credit settings, as well as administering the tax; and the Norwegian wealth tax previously had a local component (OECD, 2018c).

In practice, countries that have applied net wealth taxes have tended to exempt some types of assets – most commonly, to enhance fairness (e.g., primary residences), promote social objectives (e.g., pension assets), or support entrepreneurship and investment (e.g., business assets) (OECD, 2018c). Such tax exemptions, however, create distortions in savings and investment decisions and expand avoidance opportunities. They are particularly economically damaging if, as is often the case, they favour non-productive assets such as housing over more productive asset types. For

this reason, the OECD argues that it is better to apply an overall tax exemption threshold rather than exempt particular classes of asset, such as household effects or pension savings, if countries want to pursue such objectives through their tax design (OECD, 2018c).

Given the challenges discussed above, most countries tax particular categories of asset rather than all wealth comprehensively. Land and property taxes are generally agreed to be amongst the most economic growth-friendly (or least growth damaging) type of tax and can be designed to be progressive by linking rates to values. Although only levied on a portion of the taxpayer's assets, they provide a large tax base, since housing is the main form of wealth across households, and one that is unmovable, avoiding distortions and resulting behavioural responses, avoidance and evasion opportunities. Conversely, lighter taxation of some forms of land and property with zero or lower rates, as in the UK, is both inefficient and unfair – pushing investment towards less productive assets and taxing capital assets much more lightly than labour income.

The need for comprehensive reform of land and property taxation in Scotland is well recognized, to move from a tax system that encourages wealth accumulation through ownership of land and homes, encourages property speculation and disadvantages younger people, to wealth that is created "by effort, innovation and entrepreneurship" (e.g., Maclennan, 2021). Reform Scotland has previously argued for a land value tax at local level, where local authorities feel they are appropriate (RS, 2015). A recent David Hume Institute public engagement found a widely perceived need to replace Council Tax with a wider land tax and recommended an independent Commission review all potential tax bases for sub-national governments (Maclennan, 2021). At a minimum, given the widely recognised undesirability of transaction taxes, there are strong arguments for replacing LBTT with a more comprehensive land tax.

Implications

Both the OECD and IMF conclude that, in general, reforming and potentially increasing existing capital income, inheritance and property taxes, is likely to be preferable and easier to administer than introducing net wealth taxes (OECD, 2018c; IMF, 2021). This conclusion depends, however, on the existence of broad-based and well-designed capital income, inheritance and property taxes in the country in question.

If these aren't in place, or if taxation of capital income is relatively low, these organisations conclude that the case for a net wealth tax is stronger and that such a tax may be less distortionary than if capital income is taxed more highly and comprehensively. In addition, the justification for a net wealth tax will be greater in countries with very high levels of wealth inequality, given that taxes on wealth transfers and capital income alone are not enough to address this.

There are also complex and dynamic interactions between wealth taxes and capital income taxes that need to be weighed up in designing both. Taxes on capital income will tend to reduce the net expected return on assets, and therefore their value, which in turn will impact on the value of any wealth tax base. Changes in the taxes levied on housing, for example, will generally have a strong impact on house prices (i.e., be

capitalized into house prices) because the supply of immovable property tends to be slow to change. Conversely, a reduction in capital income taxes will tend to increase asset values and provide a windfall gain to existing asset owners. Relief on mortgage interest will lower people's income tax contribution but may increase the value of immovable property which will broaden the property or wider wealth tax base (OECD, 2018c). The overall effects, both distributionally and in terms of overall tax revenues, will depend on a host of factors that need to be assessed in detail for any given context.

Clearly, there is an urgent need to reform existing UK wealth taxes, including capital gains and inheritance taxes. The UK Wealth Commission has explored the pros and cons of a net wealth tax, or tax on additional categories of asset such as land, at UK level; similar comprehensive consideration is warranted at Scottish level, given the Scottish Government's power to introduce new taxes with the agreement of the UK Government.

One-off (Windfall) or recurrent taxes

Another key consideration is whether to levy taxes on a recurrent or one-off basis. In general, recurrent taxes are preferable to one-off taxes, providing an on-going revenue stream, and giving the tax system certainty and predictability. For this reason, one-off taxes are typically only applied to a group that has received a 'windfall' gain – i.e., a gain that is 'unearned' or due to luck or represents profits in excess of what might have been expected.

If they meet this criterion, however, windfall taxes are potentially efficient. They should not change behaviour in ways that are negative for the future tax take or economic performance, being retrospective and provided they are credibly "one-off" (although if they are anticipated then they will tend to be capitalised into the price of the assets in question in advance). If applied to truly windfall gains that aren't due to investment or entrepreneurship they can be argued to be fair, particularly compared to taxing, for example, workers' income. If well-designed, they are relatively easy to impose on firms and hard to avoid, producing a relatively predictable amount of revenue.

Windfall taxes are not without their critics.[49] They can be argued to be one-sided and arbitrary – they tax some 'windfalls' and not others, and they tax profits in good times but affected industries do not necessarily receive subsidies when times are bad. They are also argued to create uncertainty about the future tax regime and reduce future investment, although the validity of this argument depends on whether or not they are credibly 'one-off'.

The IMF has suggested policymakers could consider a temporary Covid-19 recovery contribution levied on incomes or wealth (IMF, 2021), while the US Senator Bernie Sanders has introduced legislation to reinstate the windfall profits tax previously used in the US after the First and Second World Wars and the Korean War. This would apply to large corporations (revenues of US$500 million pa) and tax 95% of their profits

[49] See, for example, https://www.economist.com/finance-and-economics/2022/03/19/governments-are-proposing-windfall-taxes-on-energy-firms

in excess of their average profit level from 2015-2019, adjusted for inflation, for three years.[50]

The EU has suggested member countries consider a windfall profits tax on oil companies and invest the revenues in renewable energy and energy-saving renovations.[51] US Democrats have just introduced similar legislation with the revenues to be used to provide quarterly income-related rebates to consumers.[52]

In the UK, an IFS assessment has concluded that there may be a case for a windfall tax on North Sea Oil profits, given that the asset is immobile (making international competitiveness irrelevant), and because the way the tax regime works is fairly close to a cash-flow tax so high rates shouldn't encourage future investment – indeed, the CE of BP has said that there are no planned investment projects that would not proceed in the event of a windfall tax.[53] The argument that a windfall tax would be one-sided is difficult to sustain in relation to oil and gas companies given that the subsidies provided by reliefs and allowances have enabled them to pay 'negative' tax in poor years (IFS, 2022). The IFS have also pointed out, however, that since overall North Sea oil taxation is lower than it has been in the past and there are tax breaks for investment, there is a case for higher taxes on a permanent rather than one-off basis (IFS, 2022).

Broadening tax bases

Along with taxing new things, the main way countries can raise additional revenues is by broadening their tax bases. The breadth of a base depends on the scope of goods, activities or groups that the tax applies to and the extent of exemptions and reliefs – known as 'tax expenditures' (TEs).[54]

The benefit of a broad base – a broad definition of the income or activity that is subject to a tax – is that it enables a government to raise *more* revenue from *lower* rates of tax. All else being equal, if a tax has a lot of exemptions and reliefs, it will need to have higher rates to raise the same level of revenue. Fewer exemptions and reliefs also reduce distortions and the inequalities that can arise from them and creates a simpler tax system with less opportunity for avoidance.

Countries often use base-broadening to offset other changes that would reduce revenues. New Zealand's major tax reforms in the 1980s, for example, which included reducing the top marginal rate of income tax from 66% to 33% and corporate income tax from 48% to 28% were largely financed by removing the tax concession for pension

[50] https://www.sanders.senate.gov/press-releases/news-sanders-introduces-legislation-to-reinstate-the-wwii-windfall-profit-tax-to-combat-rising-inequality-inflation-and-corporate-profiteering/

[51] https://www.reuters.com/business/energy/exclusive-tax-energy-firms-windfall-profits-raise-green-cash-eu-tell-countries-2022-02-28/

[52] https://robertreich.substack.com/p/windfall-profits?s=r This would tax half the difference between oil companies' current profits and their average profits between 2015 and 2019.

[53] https://www.thetimes.co.uk/article/bp-undermines-no-10-claim-that-windfall-tax-will-hit-investment-qmlsbwkg8

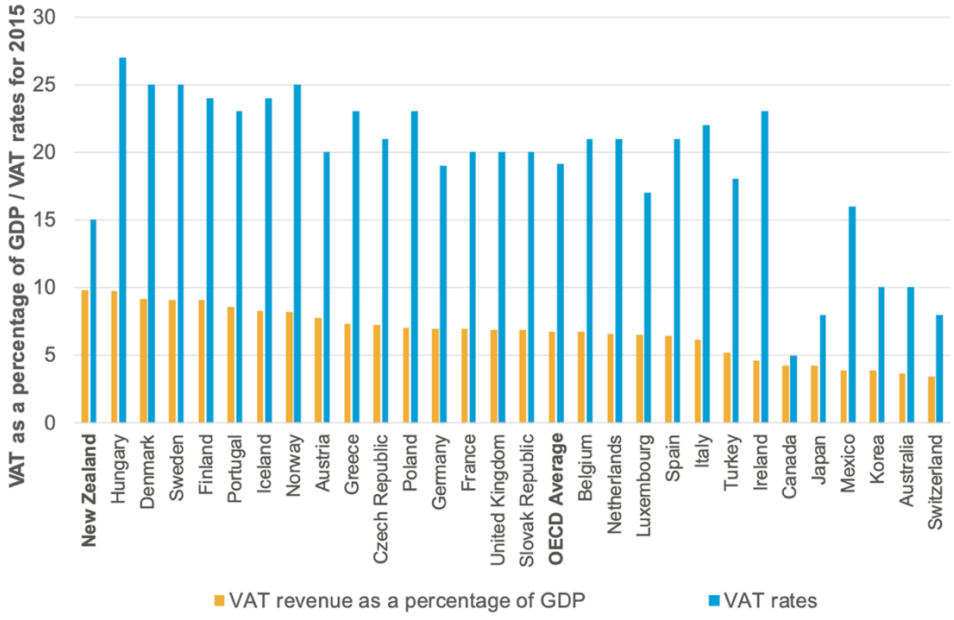
[54] Tax expenditures (TEs) include any benefits granted to specific sectors, activities or groups through preferential tax treatments including exemptions, deductions, credits, deferrals, or lower tax rates. Essentially, they are any departure from the 'standard' tax applied in a system (Von Haldenwang et al., 2021).

savings which mainly benefitted higher income taxpayers, and introducing a very broad-based goods and services tax. Norway's and Sweden's move to a 'dual rate' for taxing income that included lowering tax rates on capital (including corporate) income generated a significant revenue gain in part as a result of capital income base-broadening.

Value of a broad tax base for revenues

The importance of a broad tax base for revenues can be illustrated by comparing New Zealand's Goods and Services Tax (GST) with broad consumption taxes in other countries. New Zealand's GST is amongst the most comprehensive consumption taxes in the world with only very limited exemptions, limited use of zero rating and inclusion of government services as GST taxable. This enabled New Zealand to collect the highest level of GST/VAT revenue as a proportion of GDP out of all OECD countries in 2015 despite having the 6th lowest rate of 15% (NZG, 2018). By comparison, the UK collected much less revenue despite its significantly higher 'headline' rate of 20%.

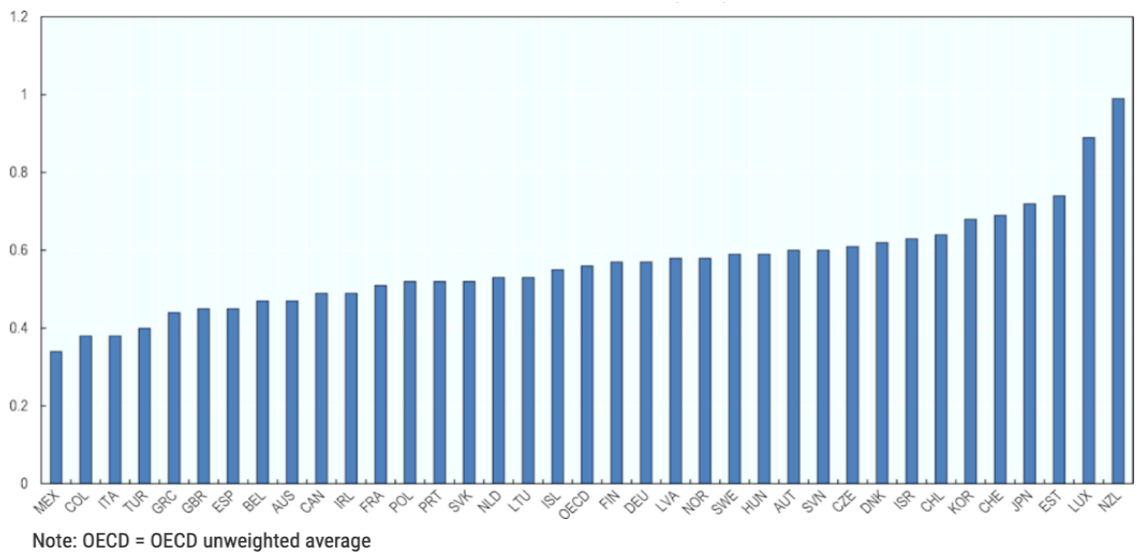
Value-added taxes as a percentage of GDP (2015)



Source: NZ, 2018

This can also be illustrated by comparing VRRs – a measure of the revenue raising performance of a VAT system. A ratio of 1 reflects a VAT system that applies a single VAT rate to a comprehensive base of all expenditure on goods and services consumed in an economy, with perfect enforcement of the tax. Across the OECD, the unweighted average VRR is 0.56 which means that, on average, 44% of the theoretical potential VAT revenue is not collected (OECD, 2020a). The VRR for New Zealand is estimated to be 0.99 due to its broad base, while the UK's VRR is well below the OECD average at 0.45 – that is, the 20% VAT applies to less than half of the potential consumption tax base.

VAT Revenue Ratio (VRR) 2018



Source: OECD, 2020a

TEs comprise very significant revenues foregone for governments. The Global Tax Expenditures Database estimates that revenues forgone across VAT, income and property taxes in the UK in 2020 amounted to 8.13% of GDP or £172 billion.[55] Zero-rating alone results in the UK Government forgoing around £50 billion pa compared to the revenues it would generate if the headline 20% rate was applied (Miller, 2020).

Similarly, temporary reliefs on business rates in Scotland have cost the Scottish Government over £700 million pa.[56] The further reliefs on business rates announced for the first three months of 2022/23 will largely eat up the additional revenue that is expected to be generated by freezing the income tax higher rate threshold in Scotland,[57] moving the tax contribution further away from businesses (or, in effect, commercial rental property owners) and towards workers.

As such, TEs are equivalent to spending but, unlike direct spending, there is much less transparency around them in many countries, including in the UK.[58]

Effectiveness of tax expenditures

The argument usually made in favour of TEs is that they are important tools to support wider government goals – particularly progressivity via transfers to lower income groups, economic objectives such as encouraging employment, investment or entrepreneurship, or to encourage beneficial behaviour change such as energy consumption from renewable sources or healthy eating. There is, however, a significant

[55] https://gted.net
[56] https://www.gov.scot/publications/scottish-budget-2022-23/pages/3/
[57] The freezing of the Income Tax higher rate threshold in Scotland in 2022/23 rather than raising it in line with inflation is expected to raise £106 million of additional revenues, while Non-Domestic Rates policies that set the poundage below inflation and provide relief at 50% for the first three months of 2022/23 will reduce revenues by £96 million (SFC, 2021).
[58] Only 97 out of 218 jurisdictions have reported on TEs at least once since 1990 (Redonda et al., 2021).

literature both internationally and at the UK level that shows TEs are often ineffective or relatively ineffective at achieving their stated goals, and are often an inefficient way of doing so (Von Haldenwang et al., 2021).

Many countries provide preferential treatment for various forms of savings (e.g., pensions, tax-preferred savings accounts, homeownership) and for particular forms of capital income (e.g., capital gains). Income tax reliefs and exemptions, with the exception of tax credits for lower income groups, however, do not generally increase progressivity and are often not cost-effective. The value of tax-free allowances for medium- and high-income earners is very significant in the UK. Once the NI threshold is raised later this year, their value in cash will be more than the amount given to those on Universal Credit. For a single working adult, the tax-fee allowances will equate to £80 per week for a single adult compared to the basic UC payment of £77 per week.[59]

For savings tax breaks, for example, much depends on design, but there is clear evidence that unless these are directly targeted at low-income individuals, the wealthy benefit most – and, indeed, obtain 'windfall' gains insofar as they subsidise savings that would have occurred anyway. Tax reliefs on pensions contributions are amongst the largest tax reliefs in the UK, costing £38 billion in 2018-19, but the House of Commons has found that it is unclear whether they encourage savings in real terms. They do not help low-paid and part-time workers who earn less than the personal allowance, around three quarters of whom are women (HC, 2020). Internationally, the evidence tends to show that variable tax rates for different types of savings tends to change the *form* of savings rather than increasing savings overall (OECD, 2010b).

Similarly, preferential treatment for home ownership such as lack of taxation of imputed rent benefits (mainly older) homeowners over (mainly younger) renters, as does zero or relatively light taxation of capital gains relative to wages.

VAT exemptions, reliefs and reduced rates are also common across countries, particularly for goods deemed to be "necessities" (such as food or clothing) to improve equity for poorer households, or to support the consumption of "merit goods" such as cultural products, or to discourage consumption of goods that create social or environmental harms (Abramovsky et al., 2017). Most recently, many countries have used additional VAT reductions or exemptions for particular goods or sectors as part of their Covid pandemic response (OECD, 2020a).

Again, both the economic and equity case for this is weak:

> *These provisions are generally not well targeted to those in need, distort consumer choice, and impose additional administrative compliance costs (related to the need of drawing borderlines between standard and reduced rate goods/services)* (OECD, 2010b).

While reduced rates for 'necessities' do benefit poorer families, richer families benefit more. Zero VAT children's clothes in the UK is often presented as a way of helping poor families, but richer families spend more on children's clothes and so benefit more

[59] https://www.newstatesman.com/politics/2022/03/revealed-tax-free-allowances-to-surpass-universal-credit-incomes. Analysis drawn from Landman Economics Tax Transfer Model/Fabian Society.

in absolute terms. Many exemptions apply to goods that are clearly not 'necessities' – such as the exemptions for private school fees, domestic flights and private healthcare – all of which will be regressive (Bangham et al., 2020). 'Necessities' are also very difficult to define in practice, raising numerous boundary issues (OECD, 2010b).

In most cases, raising the VAT rate and using the revenues to fund direct transfers will be more effective at achieving equity objectives, as well as more efficient and less administratively burdensome than reduced rates or exemptions (Tetlow et al., 2020; Abramovsky et al., 2017).[60] The IFS has shown that applying VAT to food or other 'basic' items, for example, would reduce the incomes of the rich by more than the poor, raise revenues that could be used to compensate the latter, and still have money left over from the VAT paid by the richer half (Miller, 2020).

Social security systems are usually a much more effective way to redistribute:

> *The question is thus: are there better ways available to channel resources to poorer households than poorly targeted tax expenditures?*
>
> *In high-income countries, the answer is almost certainly 'Yes'. Well-developed social protection systems with targeted cash transfer schemes for poor households mean one can redistribute much more effectively than via VAT* (Abramovsky et al., 2017).

VAT breaks for "merit goods" also tend to be regressive – they may make cultural goods such as books or cultural events more available to low-income households, but these are mainly consumed by high-income households.

Reduced VAT rates are also being used to support 'green' objectives – including on train fares (Germany), green electricity (Italy), zero-emission vehicles (Norway) and energy efficient materials and products (UK). EU Finance Ministers have recently agreed new rules on VAT for consultation with the European Parliament that include adding products that are good for the environment to the list of goods and services to which Member States can apply reduced rates and removing the possibility of reduced rates and exemptions to goods and services deemed detrimental to the environment.[61]

Again, the evidence on effectiveness is not at all clear cut. Lowering VAT rates for goods with environmental benefits such as energy-saving devices, provides a subsidy to high income households who are likely to consume more of these goods, and has been found to have "ambiguous" effects on total energy use – consumption may switch from less to more efficient products, but overall consumption can also increase as a result (Copenhagan Economics, 2007). Again, definitions can be difficult or controversial, creating 'boundary' issues and both compliance and administrative costs, and increased scope for avoidance.

The UK's VAT is particularly complex and riddled with exemptions. The OTS has recommended a comprehensive review of the reduced rate, zero-rate and exemption schedules (OTS, 2017). The Resolution Foundation has argued that widening the VAT

[60] A range of other reasons why VAT exemptions, specifically, may not be as progressive as they might appear are discussed in Abramovsky et al., 2017.

[61] https://ec.europa.eu/commission/presscorner/detail/en/ip_21_6608

base would both simplify the system and boost economic efficiency, as well as being relatively cheap and easy-to-collect way to raise revenue (Tetlow and Marshall, 2019). The IMF has recommended that the UK remove preferential rates on some goods as a way to improve efficiency, increase tax neutrality and reduce pressure to cut more productive public spending (IMF, 2018).

Tax breaks are also often adopted or proposed for particular businesses or sectors, usually with the aim of boosting competitiveness, investment or entrepreneurship. These also have a mixed track record, at best. A recent evaluation of the Scottish Government scheme to help small businesses by offering them a reduction in business rates, for example, could not find any objective evidence that the scheme had improved business outcomes, despite high take-up and a cost of £2.8 billion.[62] Lower taxes on specific businesses or sectors are only likely to be beneficial where they will help attract investment that can happen in one country or another, but not both.[63]

In short, tax reliefs and exemptions come at a significant cost and many do not achieve their stated goals. This is not to say that TEs are never a good idea. Tax credits for lower income groups can increase progressivity. Tax breaks for Research and Development have been justified in some circumstances, particularly where the benefits of investment may accrue to the wider economy or society but not the individual firm making the investment. On the other side, there may be a stronger case for imposing higher rates to account for negative externalities, such as for goods that produce pollution or high energy-consumption appliances. These can improve efficiency while also raising tax revenue (OECD, 2010b).

Even where a TE might be justified, however, its cost and likely effectiveness need to be assessed and regularly reviewed relative to other ways of achieving the goal, such as regulation or direct spending of various kinds (transfers, subsidies, loans). Given their cost and evidence around effectiveness, there is a strong case for making tax bases as broad as possible, with mitigation for impacts that are regressive achieved through the most effective mechanism, which will often not be TEs.

Reforming TEs – where to start?

A reduction in TEs is an obvious way of raising more revenues while also reducing distortions and improving both horizontal and vertical equity. While the evidence is clear, governments can find it politically difficult to reduce the scope of reduced rates, even where these are regressive or where more direct transfers would have a greater impact on their stated goals.

At the UK level, a good starting point would be to reform TEs that predominantly benefit those on higher incomes, such as mortgage interest deductions or pension savings. The IMF has recommended this, along with reform of inconsistent treatment

[62] https://fraserofallander.org/an-evaluation-of-the-small-business-bonus-scheme/

[63] This also means that higher taxes are possible where the activity is location-specific and there are high economic 'rents'. This is one reason why Norway can apply an additional 56% tax on the oil and gas sector in addition to its 22% corporate tax rate – the company must be in Norway to undertake the activity and the returns are sufficient to attract investment even after this tax rate is applied (NZIRD, 2022)

of capital income (interest, dividends, capital gains) given that capital gains are "skewed towards the rich," as a "fair" way to help pay for the Covid recovery, for example (IMF, 2021; similarly Thomas, 2020).

Scotland has powers in relation to TEs for fully devolved taxes, such as NDRs. The evidence on effectiveness suggests that very careful assessment should be undertaken before tax breaks are used as a tool to help businesses. Such TEs tend to be expensive, poorly targeted and less effective than other mechanisms.

Scotland does not have powers in relation to TEs for Income Tax, and does not currently have capital income or consumption tax powers, which limits its ability to broaden these tax bases. The fact that countries often 'trade-off' rate changes with base-broadening suggest that keeping powers over tax rates and thresholds together with powers over exemptions and reliefs is desirable where possible (although this may raise administrative challenges in the UK/SG context).

In addition, in calling for the devolution of further tax powers, a key question for the Scottish Government is the approach it would plan to take, or not, to broadening the bases for those taxes.

Impact of tax policies on the environment

Climate change and environmental challenges will require profound change to existing patterns of economic and social activity, not only to decarbonise and achieve 'net zero' targets but to address biodiversity loss and other ecosystem degradation.

Green taxes will be an important part of the mix for achieving climate goals but there is now general agreement that they are unlikely to be a major contributor to fiscal sustainability. With the possible exception of carbon taxes, they are likely to be less significant as revenue-generators than other forms of taxation and less sustainable – if successful, their revenues would be expected to decline (see, for example, Bangham et al, 2020; EEA, 2022). [64] Scotland's Landfill Tax revenues, for example, are expected to reduce significantly in the run up to a ban on landfilling of biodegradable waste in 2025 (SG, 2021b).

There is also growing recognition that decarbonisation has significant distributional impacts. Carbon pricing and taxation is regressive, disproportionately affecting lower income and other vulnerable groups. A significant portion of revenues raised will need to be redistributed to offset these impacts. The EU's 'Fit for 55' package, for example, proposes that revenues from the EU Emissions Trading System covering buildings and road transport be spent on climate- and energy-related initiatives, together with direct income support for vulnerable households via a new social climate fund (EEA, 2022).

[64] Many organisations including IMF, OECD, CCC, and UK Environmental Audit Committee have made the case for a low but gradually increasing carbon tax on greenhouse gas emissions to be levied economy-wide (i.e., on a broad base) as the most economically efficient way of reducing emissions (see, for example, EEA, 2022; IMF, 2021). The IfG has concluded that such an economy-wide rax could raise significant revenues in the UK, in contrast to other more targeted measures (Hodgkin and Rutter, 2021). But, again, if the primary objective of any carbon pricing policy is to reduce carbon emissions, then revenues will decrease over time if the policy is effective.

Regulation or direct subsidies are likely to be more important or more effective at achieving green goals in many cases. The literature tends to find that mechanisms such as regulation, fees and charges, and government spending, are often more effective than tax for encouraging climate-friendly behaviour change (OECD, 2019a; for the UK, see Bangham et al., 2020).

The urgency of the climate crisis, however, means that governments should assess the impact of all policies, including the impact of wider taxation, on environmental objectives, alongside the more traditional focus on equity and economic efficiency.

There is a clear and urgent case for removal of fossil fuel subsidies embedded in the tax system via exemptions, reliefs or reduced rates, with appropriate mitigation where this negatively impacts low-income households. Although not treated as such in the UK system, tax exemptions are a form of subsidy – "choosing not to tax something through reliefs is a choice to subsidise its usage" (Krebel et al., 2016).[65] The OECD finds that around 70% of energy-related CO2 emissions are entirely untaxed internationally and some of the most polluting fuels, including coal, remain among the least taxed, providing incentives for investors and individuals to delay the switch to clean energy (OECD, 2021c).

The scale of fossil fuel subsidies in the tax system in the UK is very significant – the European Commission estimated that the UK had the biggest fossil fuel subsidies in Europe in 2016, at €12 billion pa, much more than the €8.3 billion spent on renewable energy.[66] The reduced 5% rate on household energy is effectively a large subsidy for fossil fuel use – estimated to be worth £2.2 billion, most of which goes to higher income households and also benefits the wealthy who use more energy (Green Alliance, 2020). The zero rate for passenger transport including air travel is the next most significant (Hodgkin and Rutter, 2021). The New Economics Foundation (NEF) has argued for a rapid phasing out of fossil fuel subsidies embedded in the tax system, including the VAT relief for domestic heating, if the UK is to meet its G7 commitment to end all fossil fuel subsidies by 2025, and for support to be provided to low income households during the transition to affordable clean heating (Krebel et al., 2021).

The complementary approach could be to add more 'desirable' activities to those covered by reduced or zero rates, as being proposed by the EU. The UK Government, for example, recently announced a five-year VAT 'holiday' for energy efficiency measures such as solar panels, heat pumps and insulation.[67]

As discussed above, however, proposals for additional reduced rates need careful assessment. Studies generally find the extension of reduced VAT rates for the supply of goods and services relating to renewable energy or environmental products are not necessarily the most efficient or effective way to influence consumption to combat

[65] The WTO defines 'subsidy' to include "government revenue that is otherwise due is foregone or not collected (e.g., fiscal incentives such as tax credits)", see https://www.wto.org/english/docs_e/legal_e/24-scm.pdf

[66] Cited in: https://www.theguardian.com/environment/2019/jan/23/uk-has-biggest-fossil-fuel-subsidies-in-the-eu-finds-commission

[67] https://www.thetimes.co.uk/article/vat-holiday-for-solar-panels-0jpktgd6q

climate change or support particular 'green' sectors; most arguments in favour of lower VAT rates are equally applicable to other policy mechanisms – regulation, targeted subsidies, targeted income tax changes. These all need to be "seriously appraise(d)" for any given case (Copenhagen Economics, 2007).[68] Since all reliefs incur a fiscal cost, they also constrain the ability of governments to fund climate change and environmental objectives.

All of this suggests that, at a minimum, any Governments with tax powers should include assessment of the environmental impact of any new tax proposals as a matter of course and move quickly to undertake environmental impact audits of existing taxes, including reduced rates, reliefs and exemptions, as well as the absence of taxation.

The IfG has recommended that the UK Treasury commit to a "net zero tax audit to ensure that the current tax system supports the (net zero) transition… (to) cover all taxes, not simply those the Treasury defines as environmental taxes", as well as net zero "proofing" future tax policy changes (Hodgkin and Rutter, 2021).

The Scottish Government has taken some early steps in this direction by including a limited assessment of the consumption-based carbon emissions associated with spending in the Scottish Budget.[69] It has not, as yet, included a more comprehensive assessment or extended this to include the impact of revenue-raising.

Assessments could also include consideration of how existing tax bases might be broadened by taxing activities that are driving problems such as biodiversity loss. A recent NZ Government-commissioned review, for example, suggested further work on an 'environmental footprint' or 'natural capital enhancement' tax – a tax on land according to the intensity of its use and impact on the environment (NZG, 2019). While potentially challenging to implement, these are the sorts of ideas that Scotland could explore as ways of raising additional revenue that would also contribute to environmental goals.

Finally, as noted in Chapter 1, development of new economic models such as a 'circular economy' will require development of a comprehensive framework for tax across investment, production, product use and waste management, assuming a reduction in material input and increase in reuse and recycling as a whole.

[68] See, more recently, https://news.bloombergtax.com/daily-tax-report-international/insight-using-vat-as-a-tool-to-fight-climate-change

[69] https://www.gov.scot/binaries/content/documents/govscot/publications/research-and-analysis/2021/12/scottish-budget-2022-23-carbon-assessment/documents/carbon-assessment-2022-23-budget/carbon-assessment-2022-23-budget/govscot%3Adocument/carbon-assessment-2022-23-budget.pdf

Chapter 6: Concluding remarks

This paper has argued that ***tax revenues will need to increase*** in coming years to meet on-going pressures driven by population ageing and to fund the up-front investment needed for climate change mitigation and adaptation, in Scotland as elsewhere. Additional revenues will be required to maintain current service provision, never mind improve this. At the same time, these and other structural changes such as digitalisation will erode many existing tax bases.

The scale of revenues required means that the traditional tweaks – to Income Tax or National Insurance – will not be sufficient. Even if they were, further increases to taxes on wages are increasingly seen as unfair. Instead, countries like the UK, and within that, Scotland, will need to ***broaden their existing tax bases or tax new things – or, most likely, do both.***

International comparisons make clear that there is ***no one optimal way to raise revenue***. Countries vary significantly in the level of tax and tax mix, and there are different ways to achieve quite similar levels of redistribution. In general, high spend countries are also high tax countries, but countries can raise significant revenues with lower tax rates if their taxes have a very wide base and few exemptions. That said, the choice of model for social provision does affect the level of tax revenues required – ***more universalism in social provision requires more tax revenue.***

In addition, there is also ***'no free lunch.'*** The question is not whether to raise a rate, lower a threshold, or introduce a new tax to raise revenues, any of which will generate 'losers', but whether a given option is better than the alternatives. A reduced tax contribution from one group or activity means an increased contribution from another. In addition, a country's choice in one area – such as how it treats capital and labour income – will also affect the optimal mix of taxes in other areas – such as wealth taxation.

Consistent with this, tax policy needs to be considered 'in the round' – ***it is the combined effect, including the distribution of cash transfers and public goods, not the progressivity of each tax individually, that matters for outcomes.*** The primary purpose of a tax system is to raise revenue. If a less progressive (or even regressive) tax is efficient, it can raise more revenue that can be redistributed or used to reduce tax rates to achieve greater progressivity overall. Countries therefore need to ***consider the system as a whole*** and identify which mechanism is best for each purpose within it. Not every tax needs to be progressive to have a progressive system overall.

Making tax changes in tandem, as part of a single package, can also ***help to make tax changes more politically acceptable.*** It enables 'winners' to be highlighted as well as 'losers', and the rationale for the package as a whole to be clearly explained and understood, including how otherwise regressive impacts will be compensated for. Both the Nordics and New Zealand reduced tax breaks for some groups as a way of funding significant reductions in capital and income tax rates, respectively, for example. More recently, the OECD has suggested that the introduction of a wealth tax may be more

acceptable if it is packaged together with a decrease in other taxes, such as labour taxes that affect everyone (OECD, 2018c).

The complexity of the area and existence of 'losers' means that significant tax reform is difficult. Countries such as the Nordics and New Zealand, however, show that it is possible but that a ***clear objective*** is essential. Trying to achieve multiple objectives with a tax almost always results in a complex, muddled and less effective system. Most countries have a raft of principles, but principles do not in themselves provide a clear objective and a strategy for achieving it, including choice of model. That is the job of politics and political leadership.

In considering how to use its existing tax powers, raise new taxes, or argue for further tax devolution, therefore, ***Scotland needs to consider the tax system as a whole and be clear about its direction of travel***, including the respective roles of the tax and other related systems such as social security. This includes the extent to which it is aiming, or would aim, to broaden tax bases, increase the alignment between tax rates on different forms of income, and/or shift the balance of taxation from earnings to wider income and wealth. The climate and wider environmental crises mean that fossil fuel and other environmentally damaging subsidies embedded in existing tax design need to be removed as a matter of urgency and ***all taxes, whether environmentally-focused or not, assessed for their environmental impacts.***

The other main area of opportunity, particularly should additional taxes be devolved to Scotland, lies with ***broadening existing tax bases by reconsidering thresholds, reliefs and exemptions, and zero rating.*** A broad base will raise more revenue for lower rates of tax and existing tax breaks – particularly in the UK system given their sheer number – comprise very significant 'revenues foregone' for Governments. Most importantly, they are only rarely the most effective and efficient way to achieve their stated objectives. With the exception of tax credits for low-income groups, most income tax reliefs and exemptions, including for pensions and savings, are not progressive; while reduced VAT rates for necessities do benefit 'poorer' families, they benefit richer families more.

While it can be useful to learn from the experience of other countries, ***context is critical*** and the options available to Scotland and their effectiveness, as for any country, will depend on a host of specific characteristics and preferences, and how these compare with others. Scotland has a 'flatter' income distribution than the UK as a whole; it has fewer businesses relative to its population; and business turnover is lower than for some UK regions with a similar population (Deerin and Payne, 2019). A country's size and significance also affects the extent to which tax settings will influence inward investment: companies may still want to operate in large countries like China or the US despite tax disincentives, this is usually less true for smaller countries, for example. These and other country-specific considerations need to be carefully weighed up.

Given its close integration into the UK, the risk of tax flight also puts limits on Scotland's ability to implement tax policies that are drastically different from those of the UK. This suggests that, as far as possible, ***higher or additional taxes in Scotland should focus on less mobile factors – particularly immobile wealth.*** Taxes on the ownership of wealth

are relatively economically efficient, help encourage positive wealth creation rather than "passive" wealth accumulation and are needed if a country wants to reduce (or prevent the further increase of) wealth inequalities. If they result in personal or capital flight they will tend to lead to a reduction in values which, in many cases, would improve affordability for Scottish residents. There is a strong case for replacing LBTT with a land tax and reforming Council Tax, including moving payment from occupiers to owners and aligning rates more strongly with property/land values.

While not discussed in this paper, a further important consideration is ***the effectiveness of different types of taxes at different levels of government***. Internationally, land and property taxes are a relatively small portion of the tax take at national government level but often very important at sub-national level. Some taxes can operate effectively at both national and sub-national level – there are net wealth taxes at both levels in some countries, and consumption taxes in others, although the latter tend to be more simple retail sales taxes rather than value-added taxes. Both the extent of Scottish Government powers and the practicalities of implementation may mean that new taxation is most feasible at local rather than national level. IPPR Scotland has argued, for example, that consideration should be given to local carbon, land and inheritance taxes, given that Scotland's "nearly full powers" over local tax means that policy innovation at the local level offers the greatest opportunities to broaden the tax base, including to help pay for the Covid crisis (Gunson, 2021b).

In Scotland, a dispassionate discussion of tax policies and their objectives is perhaps made more difficult by the simmering question of independence. Although not discussed in the core of this paper, even countries with well-established and long-standing tax policy capabilities need ***deep expertise to develop an effective tax strategy,*** given the myriad of considerations that need to be assessed and weighed up. Most comparable countries – including Australia, New Zealand and Ireland – have set up independent expert commissions to undertake 'root and branch 'reviews of their tax systems every five or ten years while retaining democratic oversight of decision-making. The IfG has argued for an independent tax commission for the UK to help create a more informed public debate and make space for tax reform (Tetlow et al., 2020a). A commission of this kind, perhaps chaired by an organisation such as the OECD, could be a good starting point for Scotland in developing a Scottish tax system that is fit for the 21st century.

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