reform scotland

Fit For Consumption?

Examining the case for devolution of VAT & sales taxes

Heather McCauley

March 23

reformscotland.com

About Reform Scotland

Reform Scotland, a charity registered in Scotland, is a public policy institute which works to promote increased economic prosperity, opportunity for all, and more effective public services. Reform Scotland is independent of political parties and any other organisations. It is funded by donations from private individuals, charitable trusts and corporate organisations. Its Director is Chris Deerin and Alison Payne is the Research Director. Both work closely with the Trustee Board, chaired by Lord McConnell, which meets regularly to review the research and policy programme.

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.

Reform Scotland's Trustee Board

- Rt Hon Lord McConnell of Glenscorrodale (Chairman)
- Sinclair Dunlop
- Sandy Kennedy
- Kevin Pringle
- Geraldine Gammell
- Anna Macdonald

Foreword

The question of whether control over VAT should be devolved from Westminster to the Scottish Government, and if so in what form, has been an open one for more than a decade. So far, the prospective complications of doing so seem to have outweighed the potential advantages. However, the UK's departure from the EU – membership had prevented differential rates within member states – provides an opportunity to reopen and perhaps reinvigorate the debate.

In this paper, Heather McCauley takes a clear-eyed look at the options around the possible devolution of VAT or assignation of VAT revenues. She explores different international examples of national and sub-national systems, including those of Canada, New Zealand, the US, and a variety of European countries, which offer examples as to how a change within the UK might be brought about. McCauley also investigates the impact and efficacy of consumption taxes in reaching strategic goals and in providing greater equity across society.

It is clear that as it stands – and as charts in this report clearly show - the UK is a substantial international outlier in the way it levies VAT, including in the wide range of exemptions written into its system. The old argument that 'you wouldn't start from here' would likely be in the minds of Scottish ministers were they to get their hands on the levers at a devolved level. But balancing the tax system in a way that ensures it is progressive overall, rather than simply in certain eye-catching measures, is a complex and nuanced task.

What this report makes clear is that devolution of VAT is feasible but would be complex and impose significant additional costs on business, without fundamentally broadening the Scottish Government's tax base. Assignation of VAT, based on a simple proxy, would avoid these problems while still significantly increasing the SG's fiscal autonomy. Extending the SG's tax powers to include other forms of income taxation - particularly on savings and dividends - and either devolving or creating taxes on wealth, would be much better ways of increasing the SG's financial resilience and accountability. Perhaps a little more risk and a little less comfort and ease is what modern Scottish devolved democracy needs.

Chris Deerin
Director
Reform Scotland

Introduction

The question of whether VAT should be either assigned or devolved to Scotland has been a long-running one.

The Calman Commission's final report in 2009 said that VAT had the "potential to deliver accountability given its significant yield and the transparency to the population" but that devolution to Scotland was precluded by EU law (Commission on Scottish Devolution, June 2009).

The post-independence referendum Smith Commission recommended the *assignation* of 50% of VAT revenues to the Scottish Parliament, with receipts calculated on a verified basis.[1] At the time, it was recognized that EU law would not allow for differential VAT rates within a member state, and therefore control over setting VAT rates themselves could not be devolved. The Scottish Conservatives' submission to Smith, for example, had said the party would have recommended devolution were it not for EU law.[2] The Scotland Act 2016 subsequently made provision for assignation,[3] but this has not been implemented due to difficulties in finding a reliable basis for estimating the geographic breakdown of revenues.[4]

More recently, the Scottish Government has called for full *devolution* of VAT to be considered as part of the Fiscal Framework Review currently underway (SG 2021a, b). The UK's withdrawal from the European Union (EU) has removed the legal impediment that prevented this when the UK was an EU Member.

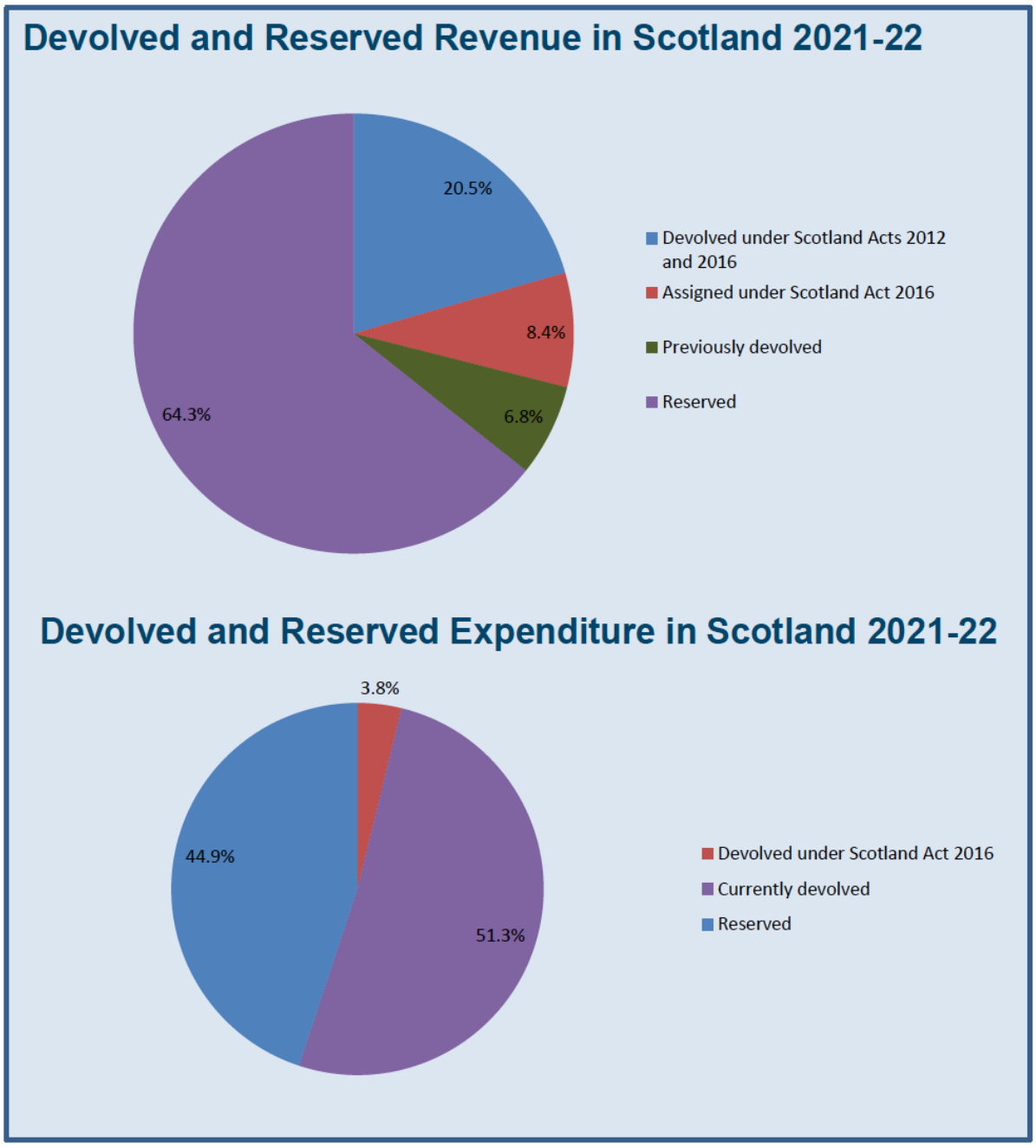
This question of tax devolution to Scotland sits in the context of the wider question of how, and by whom, the budget spent by the Scottish Government should be raised. There is a significant difference in size between the portion of the Scottish Government's budget that it raises itself, predominantly from non-savings non-dividend (NSND) Income Tax, and its spending responsibilities. Scottish Income Tax currently contributes only 27% (£12.4 billion) of the Scottish Government's non-investment funding, with 5.5% (£2.5 billion) contributed by other taxes (Phillips, 2021).

[1] Specifically, that the receipts raised in Scotland by the first 10 percentage points of the standard rate of VAT be assigned to the Scottish Government's budget with a corresponding adjustment to the block grant received from the UK Government (Smith Commission, 2014).

[2] Specifically the submission stated: "Were it not illegal under EU law, we would have been inclined to recommend that VAT be devolved to the Scottish Parliament" Scottish Conservatives, Commission on the Future Governance of Scotland, May 2014

[3] Specifically, for the first 10p of the VAT standard rate and the first 2.5p of the VAT reduced rate to be assigned to the Scottish Government.

[4] https://fraserofallander.org/vat-assignment-paused-for-now-but-will-it-be-pulled-for-good/



Source: Scottish Government, 2022.

While the Calman and Smith Commissions were both positive about possible VAT devolution, it is notable that two more recent assessments of tax devolution to other parts of the United Kingdom have concluded that taxes other than VAT are more promising candidates, at least for their contexts.

An extensive Northern Ireland Fiscal Commission assessment in 2022 concluded that while there is a case, in principle, for devolution of VAT to Northern Ireland, the uncertainty about the significant additional compliance and administrative costs likely to be involved, particularly when compared to further devolution of income tax, mean that VAT devolution should not be prioritised at this stage (FCNI, 2022).

The Institute of Fiscal Studies similarly concluded in 2019 that VAT is "a relatively poor candidate for devolution to local government" in England given the administrative difficulties involved and the relative mobility of the VAT base – i.e., consumers can change where they buy goods or services in response to differences in VAT or sales taxes (Amin-Smith, Harris and Phillips, 2019). These issues would also arise in the Scottish context.

Given this context, this paper looks again at the pros and cons of greater devolution of VAT. It considers the approaches taken in other countries where VAT or retail sales taxes (RSTs) operate at sub-national levels of government, to see what insights might be gathered of relevance to Scotland should some form of assignment or devolution continue to be considered.

In general, full devolution rather than partial or full assignation of VAT, or the creation of a Scottish VAT/RST in addition to UK VAT, is only likely to be worthwhile if Scottish Governments will want to make significant policy changes to VAT. Given this, the paper also considers where the greatest opportunities lie to improve the current UK VAT in terms of revenue-raising, increased fairness and/or improved economic or environmental outcomes.

Our previous paper, *Taxing Times*, made the case that UK and Scottish Governments will need to raise more tax revenue in the coming years and decades. This paper takes as a starting point that any tax policy changes, including further tax devolution to Scotland, will need to be at least revenue-neutral and ideally revenue-enhancing if both Scotland and the wider UK are to have a fiscally sustainable – as well as fairer and environmentally flourishing – future.

Why greater tax devolution?

There are three main reasons to consider greater tax assignment or devolution to the Scottish Government.

The first is to increase the extent to which the Scottish Government funds its own spending. Reform Scotland has long argued that the Scottish Government's tax base should be more equivalent in size to its spending responsibilities to improve transparency and public accountability. VAT raises around £10 billion pa in Scotland (SG 2021b) so if VAT was assigned or devolved it would significantly increase the portion of Scottish Government spending that the Scottish Government raises itself.

The second is that greater tax devolution would enable the Scottish Government to benefit directly from any improvement in Scotland's economic performance. Greater tax devolution would therefore increase the incentive for the Scottish Government to make policy choices that would improve economic performance because it would reap a direct financial benefit.

The third is to improve the Scottish Government's financial resilience. Under current arrangements, the Scottish Government is highly reliant on a single tax base – NSND income. This makes it particularly vulnerable to changes in the level and distribution of

employment. A broader 'basket' of taxes could help make its revenues more resilient to the business cycle, economic shocks or long-term structural changes such as population ageing or climate change. It would also enable Scottish Governments to make decisions on the optimal balance between direct income and indirect consumption taxes for Scotland.

On the downside, greater tax assignment or devolution would expose the Scottish Government to greater funding risk, particularly if revenues were volatile. If VAT rates or the tax base differed between Scotland and the UK, tax flight would be a risk, and to a greater extent than for less mobile tax bases such as property. Devolution and some forms of assignation of VAT would also create additional compliance costs for businesses and administrative costs for the Scottish Government, which could be significant depending on the model adopted.

The next section considers the role and design of broad consumption taxes like VAT internationally, and how the current UK model compares with others.

VAT internationally

Consumption taxes include both general taxes on goods and services (including value-added taxes, sales taxes, and other general taxes on goods and services) and taxes on specific goods and services (including excise taxes, customs and import duties and taxes on specific services) (OECD, 2020b).

This paper focuses on general consumption taxes.

Importance of consumption taxes

Most OECD countries apart from the US have consumption taxes as part of their 'basket' of taxes. They are a significant portion of tax revenue, contributing around one-third of revenues, on average, in OECD countries. Rates vary from less than 10% to 27%, with an average of 19.3% (2018 figures, OECD 2020a).

Consumption taxes like VAT have tended to be one of the most stable revenue sources for governments relative to the economic cycle. Recent crises have, however, shown that this depends on their design. Many countries saw significant falls in VAT revenues following the Global Financial Crisis (GFC) as the share of government consumption increased and private consumption shifted from luxuries and services towards necessities, both of which often have zero or reduced rates. On the other hand, shutdowns during the Covid pandemic resulted in plummeting consumer spending in specific sectors such as tourism and hospitality.

This is one reason why the OECD has recommended that countries carefully consider the structure of their VAT systems, particularly where different rates on different goods affect the resilience of revenues, and broaden their VAT bases (OECD, 2020b; Simon and Harding, 2020).

Types of consumption taxes

The largest source of consumption tax revenues usually comes from a broad value-added tax (VAT) or retail sales tax (RST).

A VAT is collected in a staged process on the value added at each stage of production and distribution – businesses collect VAT on sales but can receive a refund for the tax they have paid on input purchases from other businesses. As such it is a tax on the *value added at each stage of the production process*, not simply on all spending.

A retail sales tax applies a *single-stage levy at the point of final sale*. In principle, it excludes all goods and services sold from one business to another for use as an input, and simply taxes the final consumption.

Either a VAT or RST should end up having the same tax base – total final sales to customers – and therefore the same distributional and economic effects. The difference is in the mechanics of how the tax liability is collected. Under a VAT, all businesses pay (sales revenues minus the cost of inputs purchased from other businesses) while under an RST only retail businesses pay.

VAT is generally regarded as more efficient and easier to enforce than an RST because the tax is being paid at each stage in the process, reducing the incentive for any one business to evade it compared to a single, higher, sales tax. Indeed, each business has an incentive to ensure that their suppliers are paying their taxes, making VAT more self-enforcing.

This benefit may not, however, be as significant as is often claimed. Charging VAT at each stage in the process means that many more transactions are subject to tax, creating more opportunities for tax fraud. Enforcement of an RST only needs to occur at a single point (Zodrow, 1999). That said, RSTs do not have the 'self-enforcing' effect of VATs since final consumers do not have any incentive to ensure that retail sellers pay their RST liabilities.[5]

For business overall, compliance costs are more widespread under a VAT where all sales are subject to the tax unless the business's turnover falls below the country's VAT registration threshold. Under an RST, only businesses selling to final customers incur compliance costs.

Impact of consumption taxes

While VAT/RSTs are paid by businesses, they tend to be passed on to consumers (through higher prices), shareholders (lower profits) and/or employees (lower wages). As such, they are effectively an additional tax on both labour and capital income.

[5] See https://www.theigc.org/reader/value-added-tax-developing-countries-lessons-recent-research/vat-administration-faces-last-mile-problem/

The main advantage of broad consumption taxes is that they can be designed to be relatively simple and efficient. If they are applied to a large portion of economic activity, they can raise significant revenues with relatively less harm to the economy than direct income taxes.

On the economic side, consumption taxes can increase the incentive for both individuals and businesses to save and invest compared to income taxes because they do not tax the return to saving – or the 'reward' from deferring consumption – such as interest or dividends. In theory, a shift from income to consumption taxes should, therefore, support a larger capital stock and improved economic performance.

In practice, however, the empirical evidence suggests that private saving is not very responsive to the after-tax rate of return (Slamrod and Bakija, 2017). The incentive will also depend on how savings and investment are treated under the Income Tax system – in the UK, for example, many forms of pension and other savings receive tax breaks, which is another way to create this incentive.

Consumption taxes can, on the other hand, be a way to draw a greater tax contribution from the wealthy if, as in the UK, capital income is taxed at a lower rate than labour income. As such, consumption taxes such as VAT can be seen as a partial form of wealth taxation in that they tax wealth at the point at which it is *spent*.

Secondly, consumption taxes are sometimes argued to be less damaging to financial work incentives than direct income taxes. This is, however, debatable since an increase in the price of goods that a higher wage can purchase may not leave people better off overall. Any effects will therefore depend on the design of any off-setting Income Tax reductions.

The main downside of broad consumption taxes is that they can be regressive, or at least less progressive, than income taxes.

VAT will tend to be regressive in relation to people's current income – the poorest households spend more of their disposable income than the richest households. Looking at a single point in time, however, seriously overstates the regressivity of consumption taxes because most people's pattern of earning and saving changes over their lifetime. Assessment of New Zealand's Goods and Services Tax (GST), for example, has found that it is roughly proportional in relation to *lifetime* income (NZ Treasury, 2021).

The portion of income that is paid is one question but the portion of *spending* that is taken in tax is a more meaningful way to measure the distributional impact of consumption taxes. Looking at VAT burdens relative to expenditure across 27 countries, the OECD finds that they are either roughly proportional or slightly progressive in most countries. The Institute for Government (IFS) has found this is also the case in the UK (Thomas, 2020).[6]

[6] The OECD notes, however, that systems that have very few reduced rates or exemptions (i.e., a broad base) can be slightly regressive.

Of course, broad neutrality is not the same as progressivity, and direct income taxes are usually designed to be progressive, not just proportional. Like all taxes, however, the distributional impact of VAT ultimately depends not only on how revenues are raised but how they are spent. Efficient consumption taxes, even if only proportionate rather than progressive, can raise large amounts of revenue. If this is used to fund transfers to lower income households and basic public services, which tend to benefit poor households more than richer households, it can increase equity overall. It is the combined impact that matters for fairness.

Intergenerational fairness is also an important consideration. Overall, the UK's tax system tends to favour pensioners over working-age people, with working-age people's incomes taxed more heavily than pensioners' incomes while the exemption for capital gains tax on owner-occupied housing favours generally older owner-occupiers over generally younger renters. VAT *may* be more intergenerationally equitable in the sense that people pay VAT throughout their lives. That said, many necessities are exempt from VAT in the UK, and it is these that people tend to spend more of their income on in their later years. The intergenerational distribution of VAT, therefore, also depends on the 'base' of goods and services to which it is applied.

Weighting all this up, consumption taxes have a number of pros and cons compared to direct taxes on income. They can be relatively simple and efficient and raise significant revenues with less harm to the economy than direct income taxes. Their main downside is that they tend to be less progressive than income taxes – although they are not necessarily regressive and if their revenues are used to fund direct cash transfers and/or public services that primarily support those with lower incomes, they can produce greater equity overall. Much, therefore, depends on design choices for both VAT and related taxes and spending.

How does the UK compare?

The UK is fairly typical internationally in the importance of VAT in its tax mix. Like other countries, it has increasingly preferred VAT to more narrow taxes on specific goods and services. As a result, VAT now raises more than 20% of UK tax revenue, or around £140 billion pa.

The UK's 'headline' VAT rate is also around average internationally.

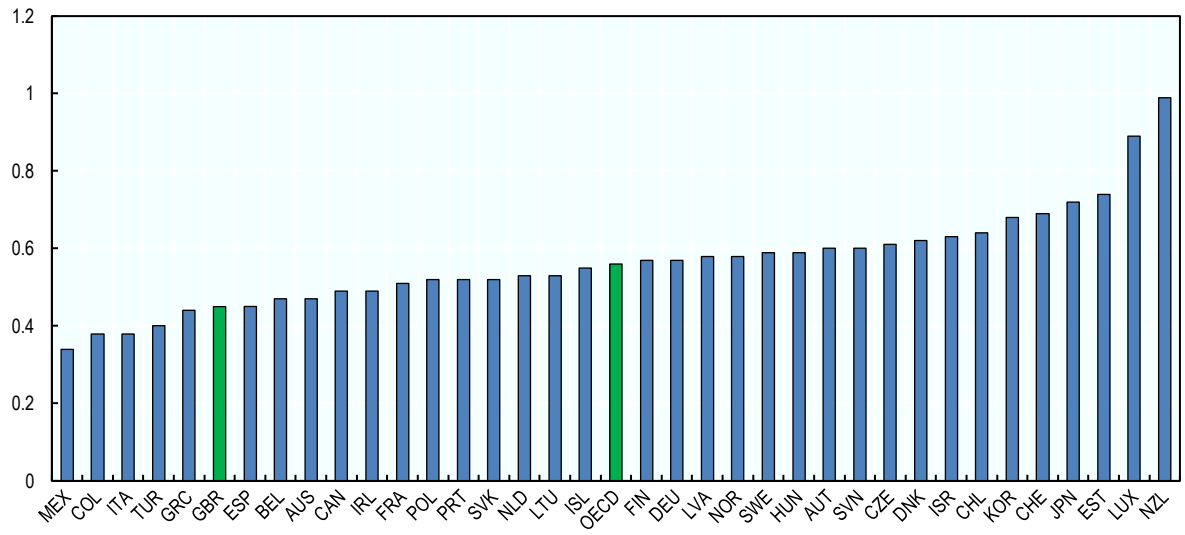
The UK's VAT is, however, unusual internationally in the extent of zero and reduced rates. It is also an outlier in its VAT registration threshold for businesses which, at £85,000, is far higher than in comparable countries. As we will see below, these features mean that the UK's VAT revenues are much lower than in countries with a broader VAT base.

The UK's VAT base

The VAT Revenue Ratio (VRR) is the standard measure for comparing the breadth of countries' tax bases. The ratio compares actual VAT revenues with the revenues that would be raised if VAT was applied to all final consumption spending.

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 UK's VRR is well below the OECD average at 0.45 – i.e., the 20% VAT applies to less than half of the potential consumption tax base.[7]

VAT Revenue Ratio (VRR) 2018



Source: OECD, 2020a

These reduced rates, reliefs and exemptions are extensive. The UK applies a zero VAT rate to a wider range of goods and services than almost any other developed country including most food and drink, children's clothing and footwear, and books. Various betting and gaming activities are exempt entirely and energy saving materials and mobility aids have reduced rates – to give just a sample of the myriad of goods involved.[8] The schedules are so extensive that HMRC lists 12 different categories of exemptions and a range of different products and factors within each.[9]

All of this comes at a significant cost. VAT zero rating reduces VAT revenues by £50 billion pa. Within this, zero-rating on food results in £20.7 billion pa of revenues foregone compared to the revenues that would be generated if the headline 20% rate was applied. A further £17.1 billion is foregone due to the zero rate for construction

[7] The Institute for Government notes that it is the UK's narrow VAT base rather than higher levels of evasion that explains the UK's low VRR ranking since European Commission data suggests that levels of VAT evasion in the UK are similar to those in other European countries with higher VRRs (Conte, Miller and Pope, 2019).

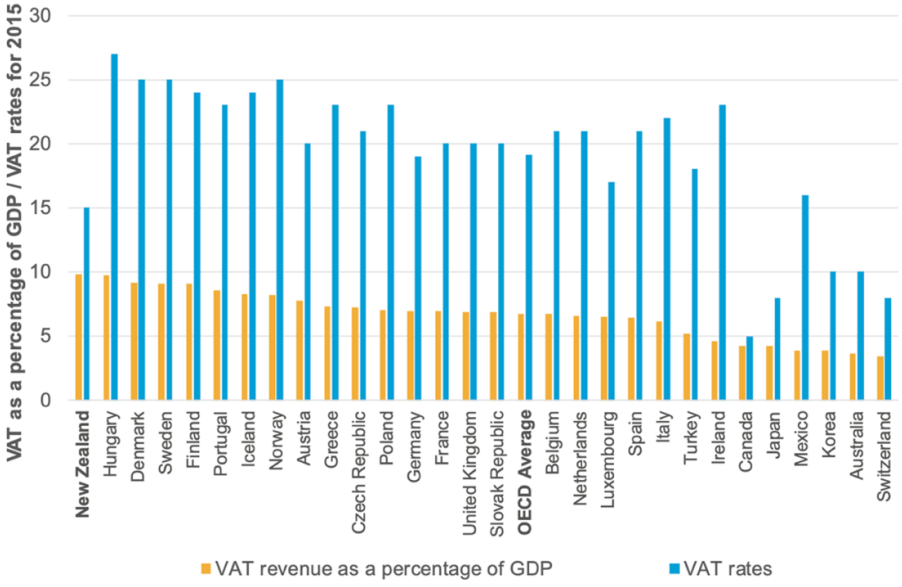
[8] See http://www.hmrc.gov.uk/vat/forms-rates/rates/goods-services.htm

[9] https://www.gov.uk/guidance/rates-of-vat-on-different-goods-and-services

and sale of new dwellings, and £4.5 billion pa due to the reduced 5% rate on domestic fuel (Miller, 2020).[10]

The impact of a broad base on revenues – and on the rates that can be adopted – can be illustrated by comparing the UK with New Zealand, which has one of the broadest consumption tax bases. New Zealand's very limited exemptions, limited use of zero rating and inclusion of government services as GST taxable, enabled it to collect the highest level of revenue as a proportion of GDP in all OECD countries in 2015 despite having the 6th lowest VAT rate of 15% (NZG, 2018). The UK collected much less revenue despite its much higher headline rate of 20%.

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



Source: NZ, 2018b

As well as reducing revenues, reliefs and exemptions complicate VAT and create boundaries that must be navigated by businesses. In the UK, some businesses will have to make sales at four different rates (standard rate of 20%, reduced rate of 5%, zero-rate and exemption). They also create bizarre anomalies across the system:

> *For example, many will remember the debates involved in determining that a Jaffa Cake is a cake (zero-rated for VAT) rather than a chocolate-covered biscuit (taxable). Every day when using a fast food outlet, you will be asked if you are 'eating in' (liable to the standard rate of VAT) or 'out' (when no VAT is due), on exactly the same sandwich. Even more mystifying, a gingerbread man with chocolate-covered trousers is subject to VAT, but not if it has chocolate eyes* (OTS, 2017).

The need for reform of the UK VAT base is well recognised. The Office of Tax Simplification has recommended a comprehensive review of the reduced rate, zero-rate and exemption schedules (OTS, 2017). The IMF has recommended that the UK

[10] HMRC Estimated cost of non-structural tax reliefs table, available at: https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs/estimated-cost-of-tax-reliefs-statistics#headline-statistics

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). The Resolution Foundation has argued that widening the VAT base would both simplify the system and boost economic efficiency, as well as being a relatively cheap and easy-to-collect way to raise revenue (Tetlow and Marshall, 2019).

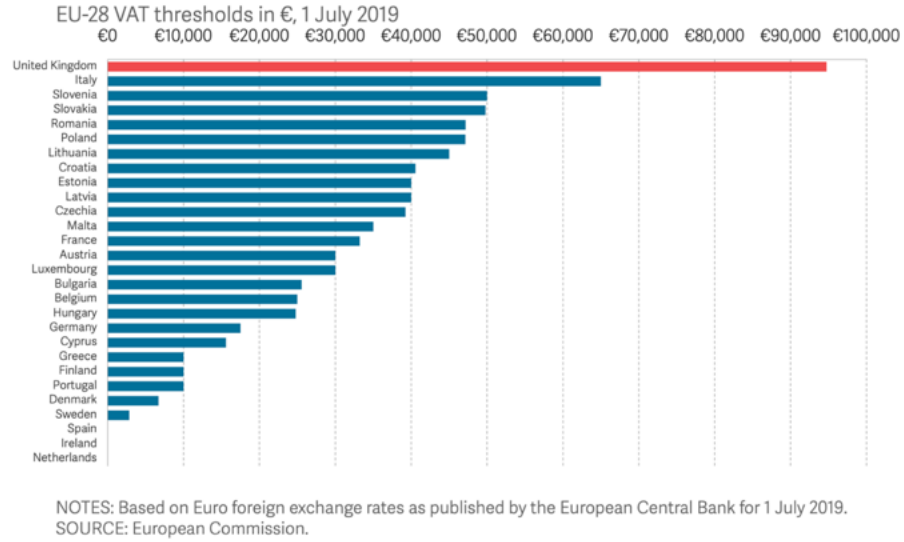
The UK's VAT registration threshold

A second feature where the UK is an outlier is in the level of its VAT registration threshold.

Most countries have a threshold below which small businesses are not required to charge or collect VAT, usually based on annual turnover. The UK is, however, an outlier in exempting businesses with a far higher turnover than in other countries.

The current UK VAT threshold of £85,000 is the highest in the OECD. It is also well above any EU country, where the average was £20,000 in 2017. 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, 2020b).

EU-28 VAT thresholds, 1 July 2019

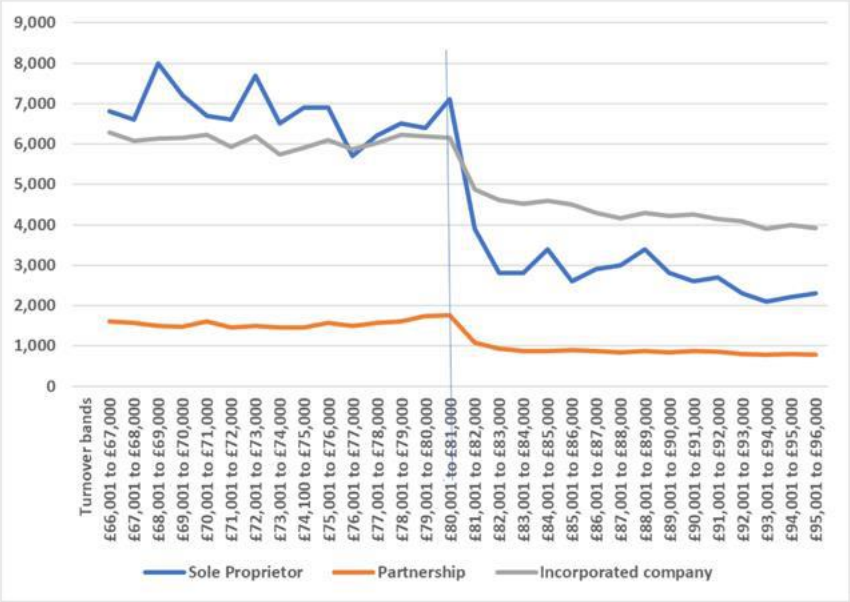


Source: Bangham et al., 2020

The UK threshold keeps around 3.55 million small businesses out of VAT but this reduces the revenues VAT can raise and has real-world impacts for the economy. It is usual across countries for businesses to tend to 'bunch' around the registration threshold but the UK's high threshold makes the effect more pronounced, distorting competition between businesses that are required to charge VAT and those that do not. This creates a disincentive for a possibly significant number of businesses to increase their productivity and grow.[11]

[11] 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

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

In 2017, the OTS estimated that a reduction in the threshold to £43,000 (as an example), which would still be relatively high by international standards, would raise between £1 and £1.5 billion pa. (OTS, 2017).

Implications

The UK's VAT is unusual in the extent of its reliefs, reduced rates and exemptions on a wide range of goods and services and in the number of businesses that are exempted from VAT registration. The impact on revenues matters because reduced revenues from VAT reliefs need to be made up either by a higher 'headline' tax rate or by increased revenues from another tax, all else being equal.

The reduced revenues and additional complexity from reliefs and exemptions may be a cost worth incurring if these are an effective way to achieve the stated policy goals. Unfortunately, this is usually not the case, as will be discussed later in this paper.

First, however, we look at examples across countries of assignation or devolution of VAT to *sub-national* levels of government.

VAT at sub-national government level

VAT or RSTs operate at sub-national level in a number of countries in two broad forms.

businesses (OTS, 2017). The UK Government froze the threshold at £85,000 until April 2022, and then extended this to March 2024, but has not yet responded to the OTS's recommendation that this be lowered. See https://www.gov.uk/government/publications/maintain-vat-thresholds-for-2-years-from-1-april-2022/maintain-thresholds-for-2-years-from-1-april-2022

The first is 'assignation' of revenues that are raised in an area or allocation of VAT/RST revenues to an area. The second is some form of devolution that give a sub-national government control over whether to impose a VAT, what rates to set and/or the tax base to which it is applied. In the latter case, it is often the simpler 'sales' (RST) rather than 'value-added' (VAT) tax that is used.

In Europe, EU rules prevent variation in VAT rates within Member States. Many EU countries have, however, put arrangements in place for sharing VAT revenues between national and sub-national governments.

European countries

In **Spain**, the 17 autonomous communities (regions) are entitled to a 50% share of VAT.[12] An index of consumption is used as a proxy for revenues to determine allocations, so that allocations are broadly equivalent to revenues raised in that region (Blöchliger and Petzold, 2009).

In **Italy**, a share of national VAT receipts is used to fund a system of general purpose equalisation grants that take into account both the expenditure needs and fiscal capacity of regions.[13]

In **Portugal**, autonomous regions receive 18.5% of the average revenue from the three major taxes (corporate income tax, personal income tax and VAT), distributed according to population, surface area and other cost factors, together with equalisation funds for less developed municipalities based on their revenue capacity and social development needs.[14]

In **Belgium**, VAT is assigned, along with personal income tax, to sub-national 'communities' (linguistically based populations). Transfers do not depend on the amount of VAT collected in an area but are calculated using an inflation-adjusted baseline together with the number of school-aged children in each community, and used to fund education (IMF, 2003).[15]

In **Germany**, around 75% of VAT revenues are distributed amongst *Länder* according to their population, along with other joint taxes that include income tax and corporation tax. The remaining 25% is then used to adjust these shares depending on the financial resources and financial needs of each Lander, to have a fiscal equalisation effect.[16]

In **Austria,** around 85% of total tax revenues are joint taxes, including revenues from personal income tax, corporate income tax and VAT. These are shared among the three

[12] https://portal.cor.europa.eu/divisionpowers/Pages/Spain-Fiscal-Powers.aspx
[13] https://www.oecd.org/regional/regional-policy/profile-Italy.pdf
[14] https://www.oecd.org/regional/regional-policy/profile-Portugal.pdf
[15] https://portal.cor.europa.eu/divisionpowers/Pages/Belgium-fiscal-Powers.aspx.
[16] https://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Oeffentliche_Finanzen/Foederale_Finanzbeziehungen/Laenderfinanzausgleich/Eng-Der-Bundesstaatliche-FAG.pdf?__blob=publicationFile&v=1; https://www.oecd.org/regional/regional-policy/profile-Germnay.pdf. https://portal.cor.europa.eu/divisionpowers/Pages/Germany-Fiscal-Powers.aspx; https://www.scoperatings.com/ScopeRatingsApi/api/downloadstudy?id=7cc85656-3d0c-4090-8fac-c68bae577527;

levels of government based on a vertical fiscal equalization mechanism that is guided by tax (regional or local tax revenue) and demographic (number of inhabitants) criteria.[17]

Assignation is also found outside of Europe, for example, in Australia.

Australia

In **Australia**, both Commonwealth and State Governments are able to levy taxes, but Commonwealth taxes cannot discriminate between States or parts of States, and duties of customs and excise may only be imposed by the Commonwealth.

For this reason, the Goods and Services Tax (GST) is imposed and collected by the Commonwealth Government. When the GST was introduced, the Commonwealth Government made an agreement with the States that the States would abolish or reduce certain taxes and the Commonwealth would in return provide all revenue from the GST to the States, according to horizontal fiscal equalization principles.

GST revenue is, therefore, not distributed to the States based on the *location* of revenues raised but, rather, to ensure that each state and territory has the fiscal capacity to provide services of the same quality to their populations.[18]

Canada and the United States both provide examples of *devolution* of VAT/RSTs. In Canada, these are in addition to a national GST; the US does not have any national-level VAT/RST.

Canada

In **Canada**, the federal government's goods and services tax (GST) is set at 5%.

Sub-national governments – states and provinces – have the choice of whether to to impose their own RSTs in addition to the federal GST. Most combine the federal GST with a provincial 'harmonised' sales tax (HST) of 6-10%, usually with the same tax base.

This results in a total HST of 11% in Saskatchewan, 12% in British Columbia and Manitoba, 13% in Ontario, 14.975% in Quebec and 15% in New Brunswick, Newfoundland and Labrador, Nova Scotia and Prince Edward Island.[19]

In contrast, Alberta, Yukon, the Northwest Territories and Nunavut have the federal GST but do not levy a provincial or territorial sales tax.

[17] https://www.oecd.org/regional/regional-policy/profile-Austria.pdf ; https://www.bmf.gv.at/en/topics/budget-economic-policy/fiscal-federalism.html

[18] https://www.treasury.nsw.gov.au/budget-financial-management/revenue-and-taxation/taxation-australia; https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/FlagPost/2011/March/Distribution_of_GST_to_the_states

[19] https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/gst-hst-businesses/charge-collect-which-rate.html; https://www.retailcouncil.org/resources/quick-facts/sales-tax-rates-by-province/

Both federal and provincial sales taxes have a zero-rated component for some items such as basic food. British Columbia, Saskatchewan and Manitoba also levy provincial sales taxes (PSTs) of up to up 20% on certain goods.[20] The PSTs are not value-added taxes like the GST/HST but simpler RSTs.

In Canada, suppliers are liable for RSTs. Cross-state issues are managed using 'place of supply rules' mean that the province in which a sale is made is the province whose GST/HST rate should apply. Out-of-province suppliers have to collect and remit any provincial sales tax. If, for example, a book is bought from a bricks-and-mortar store in Ontario by a resident of Manitoba, Ontario tax rates apply but if the same publication is ordered on-line by the same Manitoba resident, then Manitoba rates will apply. Similarly, if a store in Vancouver, BC delivers a mattress to a customer in Toronto, Ontario, the Ontario HST will apply.[21] The aim is to put suppliers outside of a province on an equal footing with those within a province.

As with a VAT, businesses can deduct/claim tax credits for any GST/HST that they have paid on their inputs from other Canadian businesses, within certain restrictions.[22] A GST/HST/RST registered vendor is required to file VAT returns and the tax authorities are entitled to perform audits to ensure tax compliance (PWC, 2020).

Administration varies. In Newfoundland and Labrador, Nova Scotia and New Brunswick, the federal government administers the provincial sales taxes, with revenues then distributed based on taxable consumption. In Prince Edward Island, Ontario, Manitoba, Saskatchewan and British Columbia, provincial governments administer their own sales taxes. In a unique case, Quebec administers both its PST and the federal GST, despite a range of differences at various times in the rates, tax base and administration that apply in each case (Bird, 2010), although current rules are largely modelled on the GST/HST (PwC, 2020).

Smaller businesses whose sales do not exceed $30,000 do not have to register for GST. Canada also provides a 'quick method' for businesses with taxable supplies of more than $30,000 but less than $400,000 (approx. £260,000) which allows them to apply a simple formula to their total revenues to calculate the GST/HST due.

[20] https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/gst-hst-businesses/charge-collect-which-rate.html; https://www.retailcouncil.org/resources/quick-facts/sales-tax-rates-by-province/

[21] https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/gst-hst-businesses/charge-collect-place-supply.html; https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/b-103/harmonized-sales-tax-place-supply-rules-determining-whether-a-supply-made-a-province.html

[22] https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/gst-hst-businesses/complete-file-input-tax-credit.html

United States

The **United States** is the only OECD country that does not levy a broad consumption tax at national government level. RSTs are, however, used at sub-national levels of government, levied on final retail sales.

Currently, RSTs are used in 45 states and the District of Columbia with rates ranging from 2.9% to 7.25%. Local governments within 38 states, such as cities and counties, also apply sales taxes ranging from around 1% to 5%. This means that there are thousands of RST jurisdictions within the country. Sales tax bases vary significantly and impact on the amount of revenue collected as well as how the tax affects the economy (Cammenga, 2021).

All businesses are required to register for RSTs – there are generally no registration thresholds.

As in Canada and internationally, RSTs are generally destination taxes, where the State in which the good or service is physically transferred to the purchaser is the State that has the right to tax the sale, and the good or service is taxable regardless of the location of the supplier. In general, the purchaser is liable for the tax but the seller is the agent responsible for collecting the tax.

Under the US Constitution, however, there are limits on a State's authority to impose tax on non-residents, particularly those whose business does not have a physical presence in the State. For this reason, States typically complement their Sales Tax with a Use Tax on purchases made out of State and brought or shipped into the jurisdiction for use, consumption or storage. If a seller fails to collect a State Sales Tax, then the user is obligated to pay a Use Tax directly to the tax authority. Again, the main purpose is to ensure that within-State sellers do not face a competitive disadvantage in relation to out-of-State sellers (PWC, 2020).

While failure to pay Use Taxes can result in fines or penalties, they are generally hard to enforce, particularly as many people aren't aware of them.

Implications

These examples show that partial or full assignation of VAT is fairly common across the EU, due in part to EU rules preventing full devolution, and is also used in Australia. Most of these countries do not assign VAT revenues on the basis of *actual* revenues raised in a particular geographic area. Instead, they use VAT revenues to achieve greater fiscal equalization between states or regions.

One exception appears to be Spain, but it uses an index of consumption as a proxy for VAT revenues raised, rather than recording the geographic location of actual VAT revenues.

The Canadian and US examples show that partial or full devolution to sub-national governments can be feasible. Prior to its GST system being adopted, the almost unanimous view of experts was that a standard invoice credit destination-based VAT could not work at sub-national government level. Canada has demonstrated that it is quite possible for sub-national RSTs to operate alongside a national RST, and for there to be variation between the approaches taken in different provinces. It also shows that VAT/RSTs can be administered at either national or sub-national level, or jointly (Bird, 2010). It is notable, however, that in Canada, the US and Australia, it is the simpler RST rather than VAT that is used.

Considerations for Scotland

The above examples show that either assignation (in part or in full) or devolution of VAT to a sub-national government, and in the latter case either to replace or sit alongside a national-level VAT, is feasible. Whether it is *desirable* for Scotland – particularly compared to devolving or creating other types of taxes – will depend on a number of considerations. These include the implications for the Scottish Government's tax mix and financial resilience, the risk of tax flight, and the practical challenges and costs that VAT devolution or the more complicated forms of assignment would raise.

The Scottish Government's tax mix and financial resilience

VAT is, ultimately, a tax on income. Since the Scottish Government already levies Income Tax on NSND income, VAT would not broaden the tax base to the extent of some other taxes. *Taxing Times* has argued that there are both fairness and economic efficiency reasons why the Scottish Government should focus instead on devolving and/or creating new forms of wealth taxation rather than taxes on income to raise any additional revenue it needs (McCauley, 2022).

That said, VAT would broaden the Scottish Government's tax base to some extent because VAT is applied to all types of income when it is spent. This includes income from savings and dividends, which are currently exempted from the Scottish Income Tax, and income from wealth when it is sold. VAT is also paid by people who are not otherwise included in the Income Tax base, such as international visitors.[23]

Adding VAT could help improve the Scottish Government's financial resilience in relation to the revenues that it raises directly to some extent, but not as much as other options such as greater wealth taxation. In addition, the stability of VAT revenues would depend in part on whether Scottish Governments were willing to broaden the VAT base to improve the resilience of revenues, as recommended by the OECD, IMF and others.

[23] The UK removed VAT refunds for overseas visitors from 1 January 2021, see https://www.gov.uk/government/news/duty-free-extended-to-the-eu-from-january-2021

Risk of tax flight

For sub-national governments, tax flight will be more of an issue for consumption taxes than more 'immobile' tax bases such as property if tax rates are significantly higher, or the goods and activities to which they apply are significantly broader, than in other parts of the country (cross-border shopping) or than are available on-line (internet shopping). Both could reduce total tax revenues and hurt domestic businesses.

For both fairness and administrative reasons, most countries apply the "destination principle" whereby a good or service should be taxable in the jurisdiction in which it is consumed.[24] It can, however, be difficult or administratively costly to ensure all imported goods are taxed, particularly low-value internet purchases.

The extent of *cross-border shopping* will depend on the vicinity of other jurisdictions, the cost of travel, the value of the goods being purchased and the existence or not of border checks. There is clear evidence of cross-border shopping in response to sub-national sales taxes in the US, particularly for major purchases, and of businesses locating just outside the boundary of high sales-tax areas to reduce their rates (Cammenga, 2021). While it is difficult to extrapolate to the Scottish/UK context, it is reasonable to assume that cross-border shopping could be a greater issue within the UK, given its smaller geographic size.

The bigger risk, however, could arise from the growth in *internet shopping*, which makes 'cross-border' shopping from a much wider range of jurisdictions much easier. This is a risk for all jurisdictions, not just sub-national ones, and many countries are taking steps to apply consumption taxes, as well as other duties, to imported goods and services, including lower-value imports that have often previously been exempt.[25] Cooperation between national and sub-national authorities – in this case, UK and Scottish – would be essential to ensure that any Scottish VAT was levied on imported goods purchased by Scottish residents. Within Canada, for example, most provinces have also made agreements with the federal government to collect their GSTs on goods imported from abroad (Bird, 2010).

It is less clear how a Scottish VAT could be applied to cross-border or internet shopping by Scottish residents from the rest of the UK in the absence of a customs or other administrative border. Conversely, any reduction in rates or additional reliefs or exemptions in Scotland are likely to be viewed negatively by other parts of the UK because of the risk of tax flight in the opposite direction. Indeed, this is one reason why the UK Government may be reluctant to consider VAT devolution.

---

[24] The OECD's *International VAT/GST Guidelines* provide proxies for determining consumption where this might be unclear - for example, for supplies of remote services or intangibles – usually based on the consumer's usual place of residence (OECD. 2017).

[25] See, for example, new rules in the UK following withdrawal from the EU that apply Import VAT, usually at 20%, to goods over £135 ordered from overseas, https://www.gov.uk/guidance/vat-and-overseas-goods-sold-directly-to-customers-in-the-uk ; new rules in New Zealand require overseas businesses that sell goods valued at NZ$1000 approx. £500 or less to consumers (private individuals) to register for, collect and return NZ GST, https://www.customs.govt.nz/about-us/news/important-notices/new-gst-rules-for-low-value-imported-goods/

Compliance costs for business and administrative challenges

While the Canadian examples discussed above demonstrate that variation between a national-level VAT and sub-national VATs is feasible, the more divergence there is between them, the higher the compliance costs for business and administrative costs for governments.

Devolution and some forms of assignation would require a much more complex system of VAT reporting for businesses in Scotland or those that are buying from or selling to businesses in Scotland, and the administrative apparatus to monitor and enforce this.

Assignation would mean that HMRC would continue to collect VAT at UK level. If a simple proxy could be agreed for Scotland's 'share', ideally tied to the level of consumption or related economic indicator, this would not impose additional compliance costs for business but would ensure that the Scottish Government would benefit in revenue terms from any improvement in economic performance and carry more of the risk of poor performance, improving accountability. The Scottish Government would not, however, have the ability to vary any aspect of VAT policy.

Devolution, or assignation based on actual verified 'value-add' in Scotland, in the absence of a customs border, would mean that businesses would have to apportion value to different stages and activities within their business, and report the locations where each occurs. This would be further complicated if VAT rates, or the goods and services to which they applied, varied between Scotland and the rest of the UK, because businesses would then need to adjust VAT refunds accordingly. For this reason, the simpler RSTs may be more practical at sub-national level than VATs, because they are applied to final sales only.[26]

Alternatively, if the Scottish/rUK border was treated as a customs border, VAT could be exempted when goods cross, and then reapplied in the jurisdiction in which consumption occurred, as occurs internationally. This, however, would be a very significant change with much wider implications.

Whether the costs of full devolution or assignation based on verified value-add are worth incurring will depend on the importance that Scotland places on additional fiscal autonomy and, in the case of devolution, the extent to which it believes it can improve the design and operation of consumption taxes. Given this, the next section discusses the changes that Scottish Governments could consider, or that have been suggested, to VAT in its current form.

Potential VAT policy changes

Using VAT reliefs to support wider policy goals

The most common proposals that have been made for adjusting VAT tend to involve rate reductions, reliefs or exemptions to support a wider policy goal. There have been

[26] As discussed by Amin-Smith, Harris and Phillips (2019) in relation to possible devolution of VAT to English local authorities.

numerous calls in recent months for VAT reductions to ease the cost-of-living crisis. Before that, the UK Government used a VAT reduction (to 5% and later 12.5%) to support the hospitality and leisure industries during the pandemic.[27]

VAT reductions are most commonly adopted or proposed *to support lower income households* by applying lower rates to 'necessities' such as food or domestic heating. Unfortunately, the evidence both internationally and for the UK shows that VAT reductions are usually not the most effective way – and almost never the most cost-effective way – to achieve these objectives. Poorer households spend more of their income on necessities, so do benefit from reduced or zero VAT rates, but richer families benefit more. Any further reduction in VAT rates for necessities would also provide a windfall gain to those with existing wealth – they will benefit from an increase in the purchasing power of their existing savings.

Numerous studies have shown that in countries with well-developed tax and benefit systems such as the UK, raising (or not lowering) the VAT rate and using the revenues to fund Income Tax reductions for the lowest bands and 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, Phillips and Warwick, 2017; Mirrlees et al., 2011). Applying VAT to food or other 'basic' items in the UK, 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).[28]

Consistent with this, reduced VAT rates on domestic heating are not the best way to support poorer households and are environmentally harmful, working against the UK's Net Zero goals, including Scotland's Net Zero goals. At the UK level, most of the subsidy provided by the reduced rate for household heating goes to the seven higher decile income groups – households in the lowest three income deciles spent £9.70 per week on domestic heating in 2019 compared to £13.40 per week in the seven highest deciles – and the wealthiest decile spends more than double that of the poorest. At £4.5 billion, the reduced VAT rate is the largest of the many subsidies that the UK Government provides to fossil fuel use (Green Alliance, 2020).

Given this, the Institute for Government (IfG) and Green Alliance have called for the standard VAT rate to be applied to household heating and the new revenue raised to be used for home improvements and subsidies for low-income households.[29]

---

[27] https://www.gov.uk/government/publications/introduction-of-a-new-reduced-rate-of-vat-for-hospitality-holiday-accommodation-and-attractions/introduction-of-a-new-reduced-rate-of-vat-for-hospitality-holiday-accommodation-and-attractions . The rate returned to the 'headline' rate of 20% in April 2022.

[28] Similarly, This was one reason why the New Zealand Government made an explicit decision not to follow the UK in exempting basic consumption items – its analysis was clear that this "would provide more – often significantly more – aggregate benefit to the rich than the poor" (Thomas, 2015).

[29] This repeats the recommendation in the 2011 Mirrlees Review, which also found a "strong case" for extending UK VAT at the full rate to domestic fuel consumption (as well as a more uniform VAT generally) and using some of the money raised to be used on compensation and measures to improve energy efficiency – noting that the UK's reduced rate contrasted with most other EU countries at the time, see Mirrlees et al, 2011.

In contrast, a further cut to the reduced rate of VAT on domestic heating would be a very poorly targeted way of helping families – most of the cost would go to better-off families – and undermine Net Zero goals by worsening the implicit subsidy for fossil fuel. The Resolution Foundation has estimated that zero-rating VAT would be worth around £124 to the typical household, a very small amount given the size of the expected increase in energy bills (Brewer et al., 2022).

Reliefs and exemptions for 'necessities' are also problematic because they are very difficult to define in practice, raising numerous boundary issues which undermines both revenues and the objectives they ostensibly aim to achieve (OECD, 2010).

It is also important to note that VAT exemptions are often applied to goods that cannot, by any stretch of the imagination, be classified as 'necessities'– such as the exemptions for private school fees, domestic flights and private healthcare (Bangham et al., 2020). All of these are clearly regressive and, conversely, their removal would be progressive and also raise additional government revenue for additional spending or to allow tax cuts elsewhere.

A second common argument for additional VAT breaks is *to encourage beneficial changes such as energy consumption from renewable sources.* The UK recently announced a five-year VAT 'holiday' for energy efficiency measures such as solar panels, heat pumps and insulation, for example.[30]

The evidence on the impact of reduced VAT rates to support green objectives, however, is mixed at best. 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. Its effects on total energy use have been found to be "ambiguous" – consumption may switch from less to more efficient products, but overall consumption can also increase as a result. Overall, studies generally find there are more effective and efficient ways to influence consumption to combat climate change or support particular 'green' sectors (Copenhagen Economics, 2007).

Appraisal of proposals to introduce VAT breaks to support green objectives also needs to consider the revenues foregone. Since all reliefs incur a fiscal cost, they also constrain the ability of governments to fund climate change and environmental objectives.

VAT reductions or reliefs are also adopted or advocated for a range of other "merit goods", whose consumption is seen as positive for society. Again, these 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.

In short, the evidence is very clear that VAT reliefs and exemptions not only come at a significant cost in terms of lower revenues but are nearly always not the most effective way to achieve wider policy goals. This may be disappointing to those advocating for

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

devolution of VAT in order to provide additional reliefs to particular goods and services, activities or groups of businesses. It is clear, however, that other policy mechanisms provide more effective, and less costly, ways of supporting these objectives in most cases.

While both the UK and Scottish Governments need to act quickly to respond to the cost-of-living crisis and jumping to a VAT reduction might appear to offer at least a partial 'quick fix', it would be much more effective in helping lower-income people and achieving Net Zero to remove zero VAT rates and reliefs, including those that support fossil fuel consumption, and use the money to accelerate home improvements while financially supporting low-income households during the transition.

On the other side, there may be a stronger case for imposing higher VAT rates to account for *negative* externalities, such as for goods that produce pollution or high energy-consumption appliances. In some cases, these can improve efficiency while also raising tax revenue (OECD, 2010). In practice, however, these are usually levied as 'per unit' excise duties that are additional to VAT rather than through a general consumption tax.

Broadening the VAT base

Were VAT to be devolved, or the Scottish Government to introduce an additional VAT/RST, the main scope for improvement – to raise more revenue, reduce inequities, reduce distortions and reduce compliance costs for business – lies with broadening its base, provided this was accompanied by appropriate off-setting measures to protect lower income households.

The case for broadening the UK's VAT base was clearly made in the Mirrlees Review which concluded that, "in practice, the case for differentiated rates looks weak and that for a broader, more uniform structure looks strong" (Mirrlees et al., 2011).[31] Similarly, the consensus view of international organisations is that countries should keep consumption taxes simple and levy a single rate on as broad a base of goods and services as possible. Differential rates distort spending choices, encourage lobbying by special interest groups, and increase the compliance and administrative costs of the system. As we have seen above, they are rarely the most effective way to support a wider policy goal and reduce the amount of revenue raised, requiring higher rates to be applied elsewhere, all else being equal. Conversely, a broad definition of the income or activity that is subject to a tax – that is, a broad base – enables governments to raise more revenue with lower rates of tax.

The OECD argues that a broad base is even more important for countries that are introducing a new VAT/RST. They note that starting with as few exceptions and reduced rates as possible is critical because, once in place, the difficulty of eliminating exemptions can mean countries have no option but to raise rates instead.[32]

[31] The Mirrlees Review concluded that there are only a few clear-cut situations where deviations from uniform rates in the form of higher rates are justified – taxes on environmental harms and taxes on goods such as alcohol and tobacco that have damaging effects on both consumers and other people.

[32] https://www.ey.com/en_nz/tax/how-vat-took-over-the-tax-world

While the evidence is clear, governments can find it politically difficult to reduce the scope of reduced rates, even where more direct transfers would have a greater impact on their stated goals. A good starting point could be to reform exemptions and reliefs that predominantly benefit those on higher incomes and replace exemptions for 'necessities' with more direct cash transfers for poorer families – freeing up revenues that could be used to make this support more generous than VAT reliefs currently provide.

Reconsidering the VAT threshold

As discussed above, the UK sets its threshold for VAT business registration at a much higher level than any comparable country, creating distortions, potentially undermining productivity, and further reducing the revenues that VAT can raise.

Again, this might seem like a difficult issue to address at a time of significant financial strain for businesses due to the energy crisis. It is important to remember, however, that the current high tax-free threshold means that the revenues foregone are having to be raised by a greater tax contribution from other taxpayers. If smaller businesses need support, this could be provided much more cost-effectively through other mechanisms.

It is notable that while the UK Government has not, to date, actively lowered the threshold as the OTS has recommended, it has also not increased it for a number of years and committed to retain the current threshold through to 2024. This means that inflation is doing some of the job of lowering it. That said, it still remains very high by international standards.

VAT and Income Tax

A final policy question or opportunity for Scottish Governments, were VAT to be devolved, would be the optimal balance between direct income and indirect consumption taxes, and whether to replace some (or all) of income tax with consumption tax.

A number of countries that have introduced a VAT/RST or raised their VAT rates have done so as part of wider tax reform that included a reduction in income tax rates – i.e., they have deliberately shifted their tax base from direct to indirect taxation of income to a greater or lesser degree.

The increase in the UK's standard rate of VAT in 1979 from 8% to 15%, for example, was used to pay for reductions in the basic and higher rates of income tax. The Coalition and subsequent Conservative governments increased taxes on consumption (VAT, air passenger duty and insurance premium tax) more than taxes on income, wealth or corporate profits (Tetlow et al., 2020).

The introduction of a single-rate value-added tax (GST) in New Zealand in 1986 was part of wide-ranging tax reform deliberately designed to broaden the tax base and reduce reliance on personal income tax. The higher prices were to be compensated for by the reduction in income tax and targeted assistance to low-income families, with direct compensation to social security benefit recipients for the inflationary aspect of the switch (Stephens, 1993).

Going further, the idea of completely replacing direct income tax with a consumption tax, potentially with rebates to eliminate the negative impact on lower-income households, has been a long-standing debate in US public policy and elsewhere (see Slemrod and Bakija, 2017; Zodrow, 1999).

These choices are also relevant at the sub-national level. In the US, states such as Tennessee have high sales taxes but no wage income tax so sales taxes are effectively the main tax on income. Others, like Oregon, have high income taxes but no sales tax (Cammenga, 2021).

If VAT was devolved, Scottish Governments would have the opportunity to adjust the balance between direct income and indirect consumption taxes in its tax mix, depending on what they assessed to be best for Scotland.

This would, however, require careful and robust analysis, including of the potential impact on savings and investment and any negative distributional impacts – both direct and indirect – and mitigation measures required.

Future-proofing VAT

Any country operating a VAT/RST needs to consider how to adjust and 'future proof' their system in the light of changing consumption patterns due to structural changes, from ageing populations to climate change mitigation and adaptation. Older people tend to spend more of their income on necessities, many of which are currently exempt from UK VAT. If the current structure is retained, this will undermine revenues – a greater issue for Scotland, potentially, than the rest of the UK given its ageing demographic.

Responses to the climate emergency and attempts to achieve Net Zero goals will also impact the level and form of consumption, given the need to reduce both materials and energy use. The Scottish Government is currently consulting the public on proposed legislation to develop Scotland's circular economy.[33] Governments need to assess how the tax treatment of investment, production, product use and waste management, including reduction of material input, reuse and recycling, will impact Net Zero and wider ecological objectives and the tax revenues that will be needed to support these (Milios et al., 2021).

More radical proposals for transformation of VAT to support climate goals have also been suggested. A 2018 study reported by the European Commission, for example,

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

suggested VAT be redesigned as a damage and value-added tax ("DaVAT") that would take account of the life-cycle impacts of products on the environment and human health, both global and specific.[34] The conservative Policy Exchange think tank has argued for VAT to be repurposed as a carbon consumption tax ("C-VAT") with VAT to be charged per tonne of CO2 equivalent.[35]

If the Scottish Government is serious about devolution of VAT and sees consumption taxation as an important part of its tax mix, then it will need to consider not only reform of the existing VAT tax base but how this will need to evolve in the coming years to at least maintain and ideally increase revenues.

Conclusion – what might this mean for Scotland?

The Scotland Act 2016 made provision for assignation of 50% of VAT revenues to Scotland[36] but seven years on this has yet to be implemented and the debate around VAT has stalled.

This paper has considered the pros and cons of greater devolution of VAT, or the creation of an additional Scottish VAT/RST, and the insights that can be drawn from approaches in other countries at both national and sub-national level.

The experience of other sub-national governments across Europe and in Australia, Canada and the US, shows that partial or full assignation or devolution of VAT are all perfectly feasible. Most countries that assign VAT to sub-national levels of government do so as part of a redistributive effort to offset inequalities in revenues raised and needs across states or territories – i.e., fiscal equalization – rather than assigning 'actual' revenues raised. Those that do link assignation to actual revenues tend to use a proxy for consumption in a geographic area, rather than adding the considerable burden for both business and government of tracing the location of each 'value-add'.

Going further and linking assignation to actual revenues or moving to full devolution is much more complex and potentially costly. These would require businesses to apportion value to different stages and activities within their business and report the locations where each occurs. Devolution or a new Scottish VAT would also increase the risk of tax flight in the form of cross-border shopping, business relocation and/or increased internet shopping. These would require agreement and cooperation with the UK Government about the treatment of VAT at the UK's international border and, within the UK, some mechanism for reporting and monitoring goods and services when they cross the border between Scotland and the rest of the UK.

[34] https://ec.europa.eu/environment/integration/research/newsalert/pdf/rethinking_value_added_tax_focus_on_environmental_damage_sustainability_516na2_en.pdf

[35] https://www.linkedin.com/pulse/making-vat-fight-climate-change-edward-birkett/

[36] Specifically, for the first 10p of the VAT standard rate and the first 2.5p of the VAT reduced rate to be assigned to the Scottish Government.

The Canadian examples demonstrate that variation between a national-level VAT and sub-national VATs is feasible, but the more divergence there is between them, the higher the compliance costs for business and administrative costs for governments. The much smaller geography in the UK, however, means that tax flight is likely to be a higher risk and, in the absence of a customs border, more difficult to police.

Given this, if the main objective is to increase the portion of Scottish Government spending that is raised by the Scottish Government, an assignation on the basis of an agreed 'proxy' for consumption is likely to be the simplest and most cost-effective option.

Assignation or devolution of VAT/RST may be feasible, but is it the best way to increase the Scottish Government's fiscal autonomy accountability and resilience?

Although levied on business, consumption taxes like VAT are ultimately taxes on income. While they have pros and cons compared to direct income taxes, our previous paper, *Taxing Times*, has sets out a range of reasons why Scotland would be better to seek devolution of powers relating to other direct forms of income taxation, including income from savings and dividends, and – especially – to explore the scope to use its powers to create new wealth taxes (McCauley, 2022).

That said, partial or full assignation or devolution of VAT would broaden the Scottish Government's tax base to some extent, reducing its reliance on NSND income, helping it to avoid the loss of tax income that occurs if individuals decide to receive their income through dividends rather than employment (with the former currently 'reserved' to the UK), and increase the extent to which its direct revenues match its direct spending. As such, it has some potential to increase the Scottish Government's public accountability, improve its financial resilience, and enable it to benefit more directly from any improved economic performance – though, as with any further tax assignation or devolution, this would also increase its exposure to the risks of poor economic performance.

This paper has also discussed the main changes that Scottish Governments could consider, or that have been suggested, to VAT in its current form, were it to be devolved or a new Scottish VAT/RST added.

The evidence is clear that reduced VAT rates, reliefs or exemptions are rarely the best way to support wider policy objectives. VAT reductions are not the most effective way to boost poorer peoples' incomes, reductions for 'merit' goods tend to be regressive, and reductions aiming to support the 'green' transition have mixed results at best.

There are, however, significant opportunities to improve the current system's fairness and economic efficiency and raise additional revenues. The two most significant lie with broadening the VAT base reducing reliefs and aligning rates, with appropriate mitigation to offset any regressive impacts, and reconsidering the threshold for business VAT registration. In both cases, the UK is currently an outlier.

Both these changes may seem difficult to address at a time of significant financial strain for both households and businesses. It is incumbent on governments, however, to make the case for these sorts of changes and ensure they are designed alongside reform of associated taxes and benefits to improve both fairness, economic performance and environmental outcomes overall.

Finally, the paper suggests that, if VAT were devolved or a Scottish VAT/RST created, Scottish Governments would need to consider what longer-term 'direction of travel' would be beneficial for Scotland in terms of the balance between income and consumption taxes and the changes that would be required to 'future proof' VAT in relation to changing patterns of consumption, whether arising from population ageing, climate change, or technological shifts.

Bibliography

- Abramovsky, L., Phillips, D., and Warwick, R. (2017). *Redistribution, efficiency and the design of VAT: a review of the theory and literature*. Institute for Fiscal Studies Briefing Note BN212. Available at: https://ifs.org.uk/publications/taking-control-which-taxes-could-be-devolved-english-local-government
- Amin-Smith, N., Harris, T. and Phillips, D. (2019). *Taking control: which taxes could be devolved to English local government?* Institute for Fiscal Studies. Available at: https://ifs.org.uk/uploads/publications/comms/R154.pdf
- Bangham, G., Corlett, A., Leslie, J., Pacitti, C. and Smith, J. (2020). *Unhealthy finances. How to support the economy today and repair the public finances tomorrow*. Resolution Foundation. Available at: https://www.resolutionfoundation.org/publications/unhealthy-finances/
- Bird, R. (2010). 'Central and subnational VATs in federal countries'. Chapter 3 of *Fiscal Reforms in the Middle East: VAT in the Gulf Cooperation Council*. Available at: https://www.researchgate.net/publication/286642006_Central_and_subnational_VATs_in_federal_countries
- Blöchliger, H. and Petzold, O. (2009). *Finding the Dividing Line Between Tax Sharing and Grants: A Statistical Investigation*. OECD, Paris. COM/CTPA/ECO/GOV/WP(2009)10. Available at: https://www.oecd.org/tax/federalism/43072896.pdf
- Brewer, M., Fry, E., Handscomb, K and Marshall, J. (2022). *A chilling crisis*. Resolution Foundation. Available at: https://www.resolutionfoundation.org/app/uploads/2022/08/A-chilling-crisis.pdf
- Cammenga, J. (2021). *State and Local Sales Tax Rates, 2021*. Tax Foundation Fiscal Fact No. 737. Available at: https://taxfoundation.org/2021-sales-taxes/
- Commission on Scottish Devolution (2009). *Serving Scotland Better: Scotland and the United Kingdom in the 21st Century*. Available at: https://www.qmul.ac.uk/law/maccormick/media/maccormick/timeline/15_06_09_calman.pdf
- Conte, M., Miller, H. and Pope, T. (2019). *How do other countries raise more in tax than the UK?* Institute for Fiscal Studies. Available at: https://ifs.org.uk/publications/how-do-other-countries-raise-more-tax-uk
- Copenhagen Economics. (2007). *Study on reduced VAT applied to goods and services in the*
- *Member States of the European Union. Final Report*. Available at:
- https://ec.europa.eu/taxation_customs/system/files/2016-09/study_reduced_vat.pdf
- Fiscal Commission Northern Ireland (FCNI). (2022). *More fiscal devolution for Northern Ireland? Final Report*. Available at: https://www.fiscalcommissionni.org/files/fiscalcommissionni/documents/2022-05/web-version-final-report-may-2022-accessible.pdf
- Green Alliance. (2020). Improving the environmental and social impact of UK VAT. Available at: https://green-alliance.org.uk/wp-content/uploads/2021/11/Added_value.pdf
- International Monetary Fund (IMF). (2003). *Belgium: Selected Issues*. Country Report No. 2003/050. Available at https://www.imf.org/en/Publications/CR/Issues/2016/12/30/Belgium-Selected-Issues-16368
- International Monetary Fund (IMF). (2018). United Kingdom: Selected Issues. Available at: www.imf.org/~/ media/Files/Publications/CR/2018/cr18317.ashx
- International Monetary Fund (IMF). (2021). *Fiscal Monitor April 2021*. Washington, DC. Available at: https://www.imf.org/en/Publications/FM/Issues/2021/03/29/fiscal-monitor-april-2021
- McCauley, H. (2022). *Taxing Times: Why Scotland needs new, more and better taxes*. Reform Scotland. Available at: https://reformscotland.com/2022/06/taxing-times-why-scotland-needs-new-more-and-better-taxes/
- Milios, L. Towards a Circular Economy Taxation Framework: Expectations and Challenges of
- Implementation. *Circ.Econ.Sust*. 1, 477–498 (2021). https://doi.org/10.1007/s43615-020-00002-z
- Miller, H. (2020). 'Reform taxes to make tax rises less painful' in *Tax Journal* website. [Blog post: 12 October]. Available at: https://www.taxjournal.com/articles/reform-taxes-to-make-tax-rises-less-painful

- Mirrlees, J., Adam, S., Besley, T., Blundell, R., Bond, S., Chote, R., Gammie, M., Johnson, P., Myles, G. and Poterba, J.M. (2011). *Tax by design*. Institute for Fiscal Studies. Available at: https://ifs.org.uk/books/tax-design
- New Zealand Government (NZG). (2018a). *Future of Tax. Submissions Background Paper*. Tax Working Group. Available at: https://taxworkinggroup.govt.nz/sites/default/files/2018-03/twg-subm-bgrd-paper-mar18.pdf
- New Zealand Government. (2018b). *Future of Tax. Interim Report*. Tax Working Group. Available at: https://taxworkinggroup.govt.nz/resources/future-tax-interim-report.html
- New Zealand Government. (2019). *Future of Tax. Final Report Volume I. Recommendations*. Tax Working Group Available at: https://taxworkinggroup.govt.nz/sites/default/files/2019-03/twg-final-report-voli-feb19-v1.pdf
- New Zealand Treasury. (2021). *He Tirohanga Mokopuna 2021. Consultation on the draft content of the Treasury's combined Statement on the Long-term Fiscal Position and Long-term Insights Briefing*. Available at: https://www.treasury.govt.nz/sites/default/files/2021-07/Treasury_LTFS%20Consultation%20Doc%20Draft%20June%202021_v22_Single%20pages%20FINAL.pdf
- Office of Tax Simplification (OTS). (2017). *Value added tax: routes to simplification*. Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/657213/Value_added_tax_routes_to_simplification_web.pdf
- OECD. (2010). 'Broad Base – Low Rate Approach: Scope and Limitations", in *Choosing a*
- *Broad Base - Low Rate Approach to Taxation*. Paris. Available at: https://www.oecdilibrary.
- org/taxation/revenue-statistics-1965-2016_9789264283183-en
- OECD (2017), *International VAT/GST Guidelines*, OECD Publishing, Paris. Available at: https://www.oecd-ilibrary.org/taxation/international-vat-gst-guidelines_9789264271401-en
- OECD (2020a), *Consumption Tax Trends 2020: VAT/GST and Excise Rates, Trends and Policy Issues*. Paris. Available at: https://www.oecd-ilibrary.org/taxation/consumption-tax-trends-2020_152def2d-en
- OECD. (2020b). *Revenue Statistics 2020*, OECD Publishing, Paris. Available at: https://doi.org/10.1787/8625f8e5-en
- Phillips,. D. (2021). *How and why has the Scottish Government's funding changed in recent years?* Scottish Election Analysis Briefing Note 1. IFS. Available at: https://ifs.org.uk/sites/default/files/output_url_files/BN321-How-and-why-has-the-Scottish-Governments-funding-changed-in-recent-years-2.pdf
- Pope, T. and Waters, T. (2016). *A survey of the UK tax system*. Institute for Fiscal Studies Briefing Note BN09. Available at: https://ifs.org.uk/uploads/publications/bns/bn09.pdf
- PWC. (2020). *A guide to VAT/GST/SUT in the Americas 2020*. Available at: https://www.pwc.com/gx/en/tax/pdf/a-guide-to-vat-gst-sut-in-the-americas-2020.pdf
- Reform Scotland. (2019). *The VAT opportunity*. Available at: https://reformscotland.com/2019/07/the-vat-opportunity/
- Scottish Conservatives, Commission on the Future Governance of Scotland, May 2014
- Scottish Fiscal Commission. (2022). *Scotland's Economic and Fiscal Forecasts. May 2022*. Available at: https://www.fiscalcommission.scot/wp-content/uploads/2022/05/Scotlands-Economic-and-Fiscal-Forecasts-May-2022.pdf
- Scottish Government. (2021a). *A fairer, greener Scotland. Programme for Government 2021-22*. Available at: https://www.gov.scot/publications/fairer-greener-scotland-programme-government-2021-22/
- Scottish Government. (2021b). *Government Expenditure and Revenue Scotland 2020-21*. Available at: https://www.gov.scot/publications/government-expenditure-revenue-scotland-2020-21/documents/
- Scottish Government. (2022). *Government Expenditure and Revenue Scotland 2021-22*. August. Available at: https://www.gov.scot/publications/government-expenditure-revenue-scotland-gers-2021-22/documents/

- Simon, H. and Harding, M. (2020). 'What drives consumption tax revenues? Disentangling policy and macroeconomic drivers'. *OECD Taxation Working Papers* 47. OECD Publishing, Paris. Available at: https://dx.doi.org/10.1787/94ed8187-en
- Slemrod, J. and Bakija, J. (2017). *Taxing Ourselves. A Citizen's Guide to the Debate over Taxes*. 5th edition. MIT Press. Cambridge, Massachusetts.
- Smith Commission. (2014). *Report of the Smith Commission for further devolution of powers to the Scottish Parliament*. Available at: https://webarchive.nationalarchives.gov.uk/ukgwa/20151202171059/http://www.smith-commission.scot/smith-commission-report/
- Stephens, R. (1993). 'Radical Tax Reform in New Zealand', in *Fiscal Studies* 14(3).
- Tetlow, G. and Marshall, J. (2019). Taxing times. The need to reform the UK tax system. Institute for Government. Available at: https://www.instituteforgovernment.org.uk/sites/default/files/publications/taxing-timesfinal.pdf
- Tetlow, G., Rutter, J., Marhsall, J. and Pope, T. (2020). *How to be a tax-reforming chancellor*. Institute for Government. Available at: https://www.instituteforgovernment.org.uk/sites/default/files/publications/how-to-be-tax-reforming-chancellor_0.pdf
- Thomas, A. (2015). *The Distributional Effects of Consumption Taxes in New Zealand*. Working Papers in Public Finance 08/2015. Available at: https://researcharchive.vuw.ac.nz/xmlui/handle/10063/4668
- Thomas, A. (2020), "Reassessing the regressivity of the VAT", *OECD Taxation Working Papers*, No. 49. OECD Publishing, Paris. Available at: https://www.oecd-ilibrary.org/taxation/reassessing-the-regressivity-of-the-vat_b76ced82-en
- Victoria University of Wellington Tax Working Group (Tax Working Group). (2010). *A Tax System for New Zealand's Future*. Available at: https://www.wgtn.ac.nz/cagtr/pdf/tax-report-website.pdf
- Von Haldenwang, C., Redonda, A. and Aliu, F. (2021). Shedding Light on Worldwide Tax
- Expenditures. GTED Flagship Report 2021. Available at: https://gted.net/wpcontent/uploads/2021/08/210820_GTED_FlagshipReport.pdf
- Zodrow, G.R. (1999). 'The Sales Tax, the VAT, and Taxes in Between—or, Is the Only Good NRST a 'VAT in Drag'?' *National Tax Journal*, vol. 52, no. 3, pp. 429–42. Available at: http://www.jstor.org/stable/41789733