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***The Scotland Bill* : tax-varying powers**

The *Scotland Bill 1997/98* [Bill 104] would provide the proposed Scottish Parliament with tax-varying powers. This paper discusses some of the arguments raised by the so-called 'tartan tax', and summarises the relevant clauses in the Bill. It does not look at the issue of local taxation, or the wider question of financing devolution. Those interested in these questions, or other issues related to Scottish devolution, are referred to the four other Research Papers on the Bill, listed overleaf.

The scope for a Scottish Parliament to vary taxes was set out in the Government's White Paper - *Scotland's Parliament* Cm 3658 - published on 24 July 1997 (pp x-xi): "Subject to the outcome of the referendum, the Scottish Parliament will be given power to increase or decrease the basic rate of income tax set by the UK Parliament by up to 3p. Liability will be determined by residence in Scotland. Income from savings and dividends will not be affected." A 1p change in the basic rate is equivalent to around £150m in tax revenue, at present. In effect the Scottish Parliament would be able to levy or to reduce income tax for basic rate taxpayers in Scotland by up to £450m.

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I Introduction

Scottish devolution has been an issue in this country's political life throughout the 20th century.¹ The most recent campaign may be dated back to the late 1980s with the formation of the Scottish Constitutional Convention. In 1990 the Convention published a document setting out a broad framework for devolution; among its proposals the report argued for the establishment of a directly elected Scottish Parliament with a defined range of powers and responsibilities which would encompass sole or shared responsibility for all functions except those retained to the United Kingdom (ie, defence, foreign affairs, central economic and fiscal responsibilities and social security policy).² In addition, the Convention proposed that Scottish expenditure should be financed by a system of "assigned revenues" (that is, all Scottish income tax, and if possible Scottish VAT, would be assigned to Scotland), and that a Scottish Parliament should be given the power to vary the rate of income tax up or down within a defined limit. In the Convention's final report, *Scotland's Parliament, Scotland's Right*, published in November 1995, the suggestion for assigned revenues was dropped, and it was recommended that the Parliament's power to increase or decrease income tax should be limited to changing the basic rate of tax by a maximum of 3p in the pound. In addition, it was felt that the Parliament should not have any powers to vary corporate taxation.

In its 1997 election manifesto the Labour party made the commitment to set up "a Scottish parliament with law-making powers, firmly based on the agreement reached in the Scottish Constitutional Convention, including defined and limited financial powers to vary revenue, and elected by an additional member system ... As soon as is possible after the election we will enact legislation to allow the people of Scotland to vote in a referendum on our proposals, which will be set out in a White Paper ... In the referendum we will seek separate endorsement of the proposal to create a Scottish parliament, and of the proposal to give it defined and limited financial powers to vary revenue. The Scottish parliament will extend democratic control over the widespread responsibilities currently exercised administratively by the Scottish Office ... Following [a majority in the Scottish referendum] we will introduce in the first year of the Westminster Parliament legislation on the substantive devolution proposals outlined in our White Paper."³

The Labour Government set out its plans in a White Paper published on 24 July 1997. On the question of taxation it explained, "the control of local authority expenditure, non-domestic rates and other local taxation will be devolved to the Scottish Parliament. Subject to the outcome of the referendum, the Scottish Parliament will be given power to increase or decrease the basic rate of income tax set by the UK Parliament by up to 3p. Liability will be determined by residence in Scotland. Income from savings and dividends will not be affected. The Inland Revenue will administer any tax variation, with the Scottish Parliament meeting the administrative costs."⁴ At present it is estimated that a 1p change in the basic rate is

¹ An overview of the devolution debate in Scotland is provided in *Scotland and Devolution*, Research Paper 97/92 29 July 1997.

² Scottish Constitutional Convention, *Towards Scotland's Parliament*, 1990

³ *New Labour: because Scotland deserves better*, April 1997 pp 32-33

⁴ *Scotland's Parliament* Cm 3658 July 1997 pp x-xi

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equivalent to around £150m in tax receipts from Scottish taxpayers. In effect the Scottish Parliament would be able to levy or to reduce income tax for basic rate taxpayers in Scotland by up to £450m.

Legislation to provide for both referendums received the Royal Assent on 31 July.⁵ The Scottish referendum was held on 11 September 1997. Voters were asked whether they agreed that "there should be a Scottish Parliament"; and, if "a Scottish parliament should have tax-varying powers". The referendum result was seen as decisive: 74.3 per cent of the voters agreed that there should be a Scottish Parliament and 25.7 per cent disagreed on a 60.4 per cent turn out; 63.5 per cent voted in favour of tax varying powers and 36.5 per cent voted against. By contrast the referendum on the Government's proposals for Welsh devolution held on 18 September posed just the one question - whether voters agreed that "there should be a Welsh Assembly" - since it is not envisaged that the Welsh Assembly should be given similar tax-varying powers.⁶

It is important to emphasise that granting this supplementary power stops well short of devolving national taxation. Indeed the sums of money at stake are small when one considers that, at most, it represents about 3% of the Scottish Office's budget.⁷ This may be one reason why there has been relatively little discussion of this issue, beyond the principle that the Scottish Parliament should have some influence over income tax. Nevertheless it could be said to have an important symbolic function, underlining the shift in power from Westminster to Scotland. When the White Paper was debated on 31 July 1997 the Secretary of State, Donald Dewar, argued that providing the Parliament with this limited discretion was right, "because it asks the Scottish Parliament to face real financial choices and makes it, in a sense, more directly accountable to the people it represents."⁸

The *Scotland Bill 1997/98* [Bill 104] was introduced on 17 December 1997, and is due to have its Second Reading on 12 January 1998. The Bill provides for the establishment of a Scottish Parliament and the Scottish Administration. Provisional estimates for the costs associated with the Scottish Parliament's power to vary income tax are given in the Bill's memorandum. The direct costs to the Government of establishing the mechanisms for administering the Parliament's tax varying power are estimated at around £10m, incurred largely by the Inland Revenue. The Revenue will also incur running costs, which are expected to be around £8m per annum, but may vary depending upon whether or not the Scottish Parliament chooses to vary the rate of tax. The Department of Social Security will incur set-up costs of around £6m, and annual running costs of around £1m (again, subject to whether the Parliament chooses to vary the rate of tax).

The remainder of this paper is organised as follows. Part II examines the previous attempt to bring devolution to Scotland by the Labour Government of 1974-79, when it was decided that

⁵ *The Referendum (Scotland and Wales) Act 1997*

⁶ *The Government of Wales Bill: Devolution and the National Assembly*, Research Paper 97/129 4 December 1997 provides an overview of the Welsh devolution debate and the Government's legislation to establish a National Assembly in Wales.

⁷ The Scottish Office's budget for 1998-99 is £14.6 billion [HC Deb 10.12.97 cc 562-564W]

⁸ HC Deb 31 July 1997 c.465

a future Scottish Assembly should not have any devolved tax powers. Parts III, IV and V look at the recent debate on devolving tax powers prior to the introduction of the *Scotland Bill*, in the context of the 1997 White Paper, the *Referendum (Scotland and Wales) Bill*, and the Scottish referendum campaign. Part VI discusses the main arguments for and against granting the Scottish Parliament tax-varying powers.

Finally part VII examines those clauses in the *Scotland Bill 1997/98* - clauses 69 to 75 - which make provision for the Parliament's tax-varying power. In brief these clauses:

- prohibit the Parliament from varying the basic rate of income tax by more than 3% (ie, 3p);
- provide that income from savings and distributions is to be exempted;
- define a Scottish taxpayer as someone who is resident in the UK for tax purposes, and for whom Scotland is the part of the UK with which he has the closest connection (this will normally be determined by reference to the period of time a person spends in Scotland or has his principal UK home in Scotland);
- require the UK Treasury to propose amendments to the Parliament's tax-varying power in the event of any changes in the UK tax structure which would impact significantly on the Parliament's tax-varying power;
- provide that if tax is increased in Scotland, the extra resources will be paid into the Scottish Consolidated Fund; and that if it is reduced, the resources foregone by the Parliament will be paid to the Inland Revenue out of that Fund.

In addition, clause 98 of the Bill deals with the interaction between the tax-varying power and the social security system.

II The 1979 Scottish Assembly & financing devolved services

It is notable that in the previous attempt to bring devolution to Scotland, the plan for a Scottish Assembly made by the Labour Government of 1974-79,⁹ it was proposed that the Assembly should not have any independent powers of taxation. The then Government decided against giving an Assembly any devolved tax powers in July 1977, when it published a White Paper on how devolved services should be financed.¹⁰ Two main methods of finance were considered - in line with the conclusions of a Royal Commission¹¹ which had reported on the constitution in October 1973:

- (a) the revenue basis under which a devolved administration would be given certain sources of revenue and would be obliged to finance the devolved services out of the income those sources produced; and
- (b) the expenditure basis under which the expenditure requirements of the devolved services would be measured and the devolved administration would then be furnished with the income needed to meet them.

The Government suggested that the expenditure-based system was preferable, arguing the revenue basis would be incompatible with the distribution of resources to the different parts of the United Kingdom according to their needs.¹² It was pointed out that separate systems of taxation would result in considerably greater collection costs. However, under an expenditure-based system the devolved administrations might still be given powers to levy limited additional taxation in order to finance extra expenditure which they might think especially important. In assessing whether any supplementary tax could be used in this manner, the White Paper used eight criteria reproduced below:

- (i) the tax must be operable as a marginal supplement, capable of being turned on and off as needed;
- (ii) it must be cheap to collect in relation to the revenue to be raised;
- (iii) it should fall on Scotland or Wales only and not be paid directly or indirectly by English taxpayers; conversely it should not permit evasion by a change of business location;
- (iv) it must be compatible with European Community requirements;
- (v) it must be broadly based and not restricted to special groups;
- (vi) it should not significantly affect the management of the United Kingdom economy;
- (vii) it should be seen by those paying it as a tax imposed by the Scottish or Welsh Assembly and not be lost in the mass of general taxation;

⁹ Though the legislation to establish a Scottish Assembly - the *Scotland Act 1978* - received the Royal Assent, it did not take effect as the referendum on Scottish devolution held on 1 March 1979 failed to reach the necessary threshold of consent.

¹⁰ *Devolution: financing the devolved services* Cmnd.6890 July 1977

¹¹ *Royal Commission on the Constitution (Kilbrandon Report)* Cmnd.5460 1973

¹² As it had in two previous White Papers on devolution published in September 1974 (Cmnd.5732) and November 1975 (Cmnd.6348).

(viii) it must be politically possible and not just technically practicable.¹³

The Paper reviewed the possibilities of using a supplementary income tax, a supplementary VAT or sales tax, a tax on the occupation of property, supplementary taxes on companies and a range of minor possibilities. Of all these it was noted that a supplementary income tax "seems an attractive candidate at first sight because of its high yield and broad coverage", but it was ruled out, primarily on the grounds that such a tax "would impose a heavy new burden on the PAYE system and would reduce its efficiency as the Government's main revenue collector. Furthermore, because a marginal tax would be at a low rate, the cost of collection could represent as much as 20 per cent of the yield." The main burden on both employers and the Revenue would be establishing whether any individual was resident in Scotland for tax purposes so the deductions made by their employer from their monthly pay could be amended accordingly.

PAYE (pay-as-you-earn) grew out of the need during the Second World War to collect tax from the millions of individuals drawn into the income tax system for the first time. It was designed on a cumulative basis: tax withheld from the employee at the end of each pay period - say at the end of the month - would be the exact sum required. The tax charge would be calculated each month to take account of all earnings received and tax paid in the tax year up to that date. Indeed, the majority of employees continue to be covered by PAYE. The 1977 White Paper argued that the costs of combining a supplementary income tax with PAYE would be prohibitive:

These costs are high because the changes needed in order, first, to identify taxpayers resident in Scotland and Wales, and then to ensure that they pay the supplements, would affect the whole United Kingdom tax system. As things now stand, the Inland Revenue needs only an address at which it can reach a taxpayer, it does not need to establish in which country within the United Kingdom he resides. Before a supplementary tax could be operated enquiries about residence would be needed, and these could not be limited to tax offices in Scotland and Wales. This is because for the great majority of taxpayers (those dealt with under PAYE) it is the location of the employer's payroll that determines which tax office deals with their affairs, regardless of where the employee lives.

Many large employers with branches all over Great Britain have on their payroll employees resident in England, Scotland and Wales. If there were a Scottish and/or a Welsh supplement to income tax all Inland Revenue tax offices in the United Kingdom would need to find out year by year where taxpayers whose affairs were dealt with in their district lived. They would then have to instruct employers to deduct the supplement as well as the United Kingdom tax for all those who were liable to pay it as residents in Scotland or Wales.

¹³ Cmnd.6890 p.6 These criteria were first set out by the then Secretary of State for Scotland Bruce Millan during the Second Reading of the *Scotland and Wales Bill 1976/77* - the forerunner to the *Scotland Act 1978* [HC Deb 14 December 1976 cc 1273-1276].

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Because income tax is an annual tax, and the weekly or monthly deductions from earnings under PAYE are made on a cumulative basis, it would not be possible, when collecting the supplement, to take account of changes of residence during the tax year or for some time before it began. In order to deduct the supplement, employers would have to be told before the start of the tax year of the residence status of their employees, and for this to be done residence status would have to be determined some time earlier, probably on the basis of a statutory declaration of residence made by individual taxpayers. Accordingly, the supplement would apply not only to current residents in Scotland and Wales (wherever they worked) but also to any employees who had moved from Scotland or Wales since the qualifying date. An employer in any part of the United Kingdom might therefore be required to deduct the supplement since he might have an employee who had lived in Scotland or Wales on the date on which residence for the tax year concerned was determined. An employer based in say Sheffield or Birmingham would need to apply different PAYE deductions depending on the "residence" of particular employees. Employees resident in England would come under one deduction scheme, and if both devolved administrations had decided to levy supplements at different rates there would be separate deduction schemes for residents in Scotland and Wales. Employers based in Scotland or Wales would similarly need to make special provision for employees resident outside that country. About 330,000 of the 2½ million taxpayers resident in Scotland are dealt with by tax offices south of the border; and much larger numbers of taxpayers living outside Scotland are dealt with by PAYE Centre 1 at East Kilbride and other tax offices in Scotland.

The application of the supplement to the self-employed (who are not within PAYE) does not present the same problems, since they are in general dealt with by the office relating to their place of business, and tax liability is assessed after the end of the year concerned. But there would be difficulties in applying a supplementary tax to investment income. At present, in most cases, tax on investment income is paid at source. This would not be practicable for Scottish and Welsh supplements and new arrangements would be needed for collection case by case by direct assessment at the end of the year.

The Inland Revenue estimate the annual cost to the public sector of a collection system for Scottish and Welsh taxes on the basis described above at about £15 million a year, representing 3,500 staff. About half of this staff would be taken up with the issue and receipt of residence returns, the determination of liability and the issue of codings and instructions to employers in relation to PAYE; and additional assessments and appeals in respect of investment income would account for perhaps a further 15 per cent of the additional staff. This cost (which would fall on Scottish and Welsh taxpayers) would have to be incurred to enable the tax to be levied at all and

the bulk of it would continue to arise every year even if the tax was not imposed in any particular year. If machinery was set up to levy a Scottish supplementary tax only the cost might be about a quarter less, representing say 2,500 staff. The cost to employers might be roughly as high as to the Revenue. Any one of them might have an employee living in Scotland or Wales, or liable to Scottish or Welsh income tax because he had lived there on the relevant date. As many as three different tax deduction schemes could thus be in operation simultaneously. The extra complications would add considerably to the work which PAYE, value added tax and the national insurance system already require from employers and increase the possibility of errors, thus hindering the efficient collection of taxes and contributions of all forms.¹⁴

As a consequence the Government ruled out the devolution of any specific tax powers, though the White Paper concluded "if the devolved administrations wish to have available a limited supplementary tax power and are ready to meet its administrative cost then the Government would certainly be willing to consider sympathetically any such proposals, other than in relation to off-shore oil."¹⁵

A recent study of financing regional government, produced by the Institute for Fiscal Studies in March 1996, reached similar conclusions to the White Paper - although it pointed out that some of the administrative obstacles would now be less serious because of the move to self assessment and the increased use of computers.¹⁶ The authors use a number of criteria in assessing revenue sources, including efficiency, administrative feasibility and cost.¹⁷ On this basis, they consider only *three* candidates for possible sources of own tax revenue for regional government: income tax, a sales tax (such as VAT), and non-domestic rates - ruling out the use of national insurance contributions, corporation tax, excise duties and council tax. Of these, income tax is seen to be the preferred choice, "because it is least likely to lead to major locational distortions (especially if the regional power to vary tax rates is confined to the basic rate), and because it is more transparent in its burden and incidence than either a regional sales tax or regional business rate would be, and hence might promote accountability."¹⁸ Nonetheless, the authors concede that the issues of residence, of taxpayer migration, and a greater administrative burden being placed on both individuals and the Inland Revenue, mean the introduction of a regional income tax is problematic:

Efficiency. Introducing regional variation in income tax rates would give rise to incentives for individuals to seek to be taxed in areas with low rates of income tax; to the extent that individuals are able to move between areas and do not have overriding reasons to live in a particular area, a regional income tax might induce some population movements towards areas with low tax

¹⁴ Cmnd.6890 pp 7-8

¹⁵ Cmnd.6890 p.13

¹⁶ Laura Blow, John Hall & Stephen Smith, *Financing Regional Government in Britain*, March 1996

¹⁷ The others used were: revenue stability and predictability; the need for equalisation; 'accountability' properties; equity; and, impact on the financial resources available to other levels of government.

¹⁸ *Financing Regional Government in Britain* p.60

rates. These tax-induced migration flows would be likely to be limited, for two reasons. First, many people will have reasons to stay in a particular higher-tax region, despite the difference in taxation compared with other areas; these reasons may include employment opportunities, family ties, preferences for particular locations, etc. In the case of income tax differences between regions, these factors are likely to be of much greater importance than if there were differences in income tax rates between local government districts. A second factor limiting tax-induced migration is that, if significant numbers of individuals were to try to move, this would be likely to result in offsetting changes in house prices; since the stock of housing is largely fixed except in the very long term, a higher demand for housing in low-tax areas would bid up house prices in those areas; as a result, the gains from migration would be reduced. For both these reasons, migration in response to regional income tax differences might be expected to be relatively limited, although it might be rather greater amongst high-income individuals, who would stand to gain above-average amounts from moving.

The extent of migration could be further limited by appropriate design of the regional income tax system. First, the presence of arrangements for tax-base equalisation would prevent tax differences arising because of the divergence in per capita tax base between areas. Second, the tax saving that rich individuals could make by moving to low-tax regions could be 'capped' by confining the power of regions to set the level of taxation to the basic rate of income tax; the system would then have regionally-varying basic rates of income tax, but a single national higher rate. Third, it might be appropriate to limit the regions' choice of income tax rates within a defined range - such as, for example, plus or minus two percentage points around the existing national rate.

Administrative feasibility and cost. Proposals for a local income tax in the UK have, in the past, had to confront a number of practical difficulties in devising arrangements by which the tax could be administered. Many of these difficulties arose from the particular features of the UK national income tax system, which makes extensive use of deduction-at-source arrangements to achieve an exact deduction of tax without the need for any contact between the tax authorities and the vast majority of taxpayers. It was not clear that tax rates varying according to a taxpayer's place of residence within the UK could be easily accommodated within this system, without substantial extra burdens on employers (who might have had to handle different rates of deduction for many different districts) and problems of administrative complexity in linking the deductions made on various forms of unearned income to individual taxpayers. Nevertheless, despite these problems, studies of the potential for a local income tax in the UK indicated a number of ways in which the tax could be administered, varying in the extent to which they made use of part or all of the existing apparatus of central income tax assessment and collection, and in

the additional operations required (e.g. Layfield Committee, 1976; Kay and Smith, 1988; Isaac, 1992).¹⁹

Many of the administrative problems that these studies had to tackle have been substantially eased by changes to the national income tax system, including the extensive computerisation of taxpayer records and the move to self-assessment.²⁰ Some (including, perhaps, the burden on employers) would also be eased by the smaller number of different tax rates involved in a system of regional income tax, as opposed to local income tax.

It would still be necessary for a regional income tax to involve some form of taxpayer residence declaration, and for this to be processed and enforced; this would, however, be much easier than the analogous process of poll tax registration, since, as Kay and Smith (1988) note, many of the difficult cases for poll tax have negligible incomes, and the process of allocating a given list of national income tax payers between areas has a defined end-point, whilst poll tax registration involved looking for an unknown number of individuals in each area.

It would also be necessary to decide how far the existing deduction-at-source arrangements would reflect regional variations in tax rates. It would be possible to operate with a single rate of deduction at source from labour incomes, but at the price of introducing an end-year adjustment of underpaid or overpaid tax, reflecting the difference between the regional tax rate and the rate of source deduction; this would involve much more extensive contact between taxpayers and the Inland Revenue than there is currently. It would also be possible to avoid introducing complexity into the arrangements for deduction at source on investment incomes, if the regionally-varying tax rate were only to apply to labour incomes; a system of this sort was, for example, advocated by Kay and Smith (1988).²¹

¹⁹ Layfield Committee, *Local Government Finance: report of the Committee of Enquiry* Cmnd.6453 1976; J.Kay & S.Smith, *Local Income Tax: Options for the introduction of a local income tax in the UK* report series no.31, Institute for Fiscal Studies 1988; and, A.Isaac, *Local Income Tax : a study of the options*, Joseph Rowntree Foundation 1992

²⁰ Under self assessment, which applies from the 1996-97 tax year, taxpayers who complete an annual tax return are given the responsibility for assessing their own taxable income - rather than it resting with the Inland Revenue. Generally speaking, this affects the self-employed and others with relatively complicated tax arrangements, such as directors and higher-paid employees: about 8½ million taxpayers. The remaining 17 million taxpayers are largely unaffected.

²¹ *Financing Regional Government in Britain* pp 51-53

III The 1997 White Paper on Scotland's Parliament

On 24 July 1997 the Labour Government published its White Paper on a Scottish Parliament, and the Secretary of State for Scotland, Donald Dewar, presented it to the House. Extracts from his speech are reproduced below:

Entrusting Scotland with control over her own domestic affairs will better allow the people of Scotland to benefit from, and contribute to, the unity of the United Kingdom. The Scottish Parliament will hold to account an Executive headed by a First Minister which will operate in a way similar to the United Kingdom Government. Together, the Scottish Parliament and Executive will be responsible for the wide range of domestic matters which affect everyone living in Scotland, including health, education and training; local government; housing; social work; aspects of economic development; transport, the law and home affairs; the environment, including the natural and built heritage; agriculture, fisheries and forestry; sport and the arts...

The United Kingdom Parliament is, and will remain, sovereign in all matters, but, as part of our resolve to modernise the constitution, Westminster will be choosing to exercise that sovereignty by devolving legislative responsibility to the Scottish Parliament, without diminishing its own powers. Those matters more appropriately dealt with on a United Kingdom basis will remain at Westminster. They will include the constitution of the United Kingdom; foreign policy; defence and national security; the stability of the United Kingdom's fiscal, economic and monetary system; common markets for United Kingdom goods and services; employment legislation; some health issues, including abortion; social security matters, and most aspects of transport safety and regulation ...

The financial framework for the Scottish Parliament will be based on the present "block and formula" arrangements for the Scottish Office, known as the Barnett formula, adapted to match the range of the Scottish Executive's future responsibilities and to maintain and improve transparency and accountability. This will give the Scottish Parliament the ability and freedom to approve spending decisions that are fully in accordance with Scottish needs and priorities. As an integral part of these financial arrangements, the control of local government expenditure, non-domestic rates and other local taxation will also be devolved to the Scottish Parliament, with appropriate safeguards to protect all UK taxpayers. The Government's objective is to ensure that Scotland's spending decisions are taken in Scotland, in the light of Scottish circumstances.

Subject to the outcome of the referendum, the Scottish Parliament will be given power to increase or decrease the basic rate of income tax set by the UK Parliament by up to 3p. The Parliament will have a guaranteed right to raise or to forgo up to £450 million - index-linked - irrespective of changes in the UK income tax structure. Liability will be determined by residence in Scotland, according to Inland Revenue rules. The tax-varying power will not apply to income from savings and dividends. The Inland Revenue will administer any tax variation, with the Scottish Parliament meeting the administrative costs.²²

²² HC Deb 24 July 1997 c.1041 c.1042 c.1044

The Secretary of State discussed the Scottish Parliament's limited discretion for varying income tax when the White Paper was debated on 31 July 1997:

We have added to the process the right to reduce or increase income tax at the basic rate by up to 3p in the pound, producing a levy at current terms of a maximum of about £450 million. That seems to me to be right, because it asks the Scottish Parliament to face real financial choices and makes it, in a sense, more directly accountable to the people it represents. The important point is that we are trusting the people of Scotland to make choices on their own behalf. After all, Scots elected to the UK Parliament and to local government are trusted in that way and the new Parliament should be as well.

We have built in two specific safeguards with which the House will be familiar. First, income from savings and dividends will not be affected by the tax-varying powers. We were influenced heavily in reaching that decision by the need to have a level playing field for the financial services industry in Scotland, which is particularly important in insurance and pensions. Secondly, if the Parliament's power to raise the £450 million - which will be index-linked to preserve its real value - were eroded at some hypothetical future date by changes in the United Kingdom tax structure, an alternative base with the same sort of impact in terms of distribution would be provided by the Treasury.

It is important to recognise that the power may be used to deal with some special project or difficulty. I do not expect that it would simply be added to the block-and-formula sum that is negotiated as a continuously available additional revenue support. I believe that that would constitute a misuse of the power - although, of course, it would be a matter for the Scottish Parliament. The power must be seen in the context of the United Kingdom direct taxation system as a whole. Moreover, I am advised by the Treasury that, of those who currently pay tax in Scotland, 29 per cent. would not have been affected if it had applied this year.²³ That 29 per cent. consists of those with the lowest incomes in the tax system.²⁴

Full details of the Parliament's tax varying powers were given in the White Paper:

Subject to the outcome of the proposed referendum on this issue the Scottish Parliament will be given a power to vary tax. The Government propose that the tax varying power should operate on income tax, because it is broadly based and easy to administer. Income tax is relatively simple and easy to understand and has none of the difficulties associated with the other major tax bases: different rates of VAT on different sides of the border would cause practical problems and there would be specific difficulties with EU rules; corporation tax would place an unreasonable burden on companies operating in Scotland; National Insurance is inappropriate because of its direct link with the social security system; and council tax and non-domestic rates would overburden the local government finance system and undermine the accountability of local government to its electorate.

²³ The Secretary of State is referring to the proportion of taxpayers who pay tax at the lower 20% rate.

²⁴ HC Deb 31 July 1997 c.465

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The Scottish Parliament will have the power to increase or decrease the basic rate of income tax set by the UK Parliament by a maximum of 3p. This is consistent with the recommendations of the Scottish Constitutional Convention. Since each 1p change would currently vary revenue by around £150m, the Scottish Parliament would be able to levy or to reduce income tax for basic rate taxpayers in Scotland by up to around £450m. It is of course possible that future changes to the UK income tax structure might reduce the value of the product of the Scottish Parliament's tax-varying power. In these circumstances, the Parliament's ability to raise or forgo up to £450m through the tax system will be preserved. This sum will be index linked to maintain its real value.

Any mechanism that might be required in future for protecting the Scottish tax take would be dependent upon the tax structure that was in place or had been announced at that time. As the Scottish Parliament will be fully operational from the financial year 2000-01 onwards, the appropriate arrangements would have to be jointly discussed by the Scottish Executive and the UK Government as and when such circumstances arose.

Savings and dividend income under current arrangements will not be subject to the Scottish Parliament's 3p basic rate power as it is taxed only at the lower or higher rate.²⁵ The Government believe that savings and dividend income should in future remain exempt from any income tax variation power, in order to ensure that such income is taxed on a consistent basis throughout the UK, thus avoiding economic distortion. The test of liability will be residence - a well established concept in tax law. A Scottish resident will be an individual who is resident in the UK for income tax purposes and who in any tax year either spends at least half of his time in Scotland (when in the UK) or whose principal home is in Scotland. These concepts will be set out in legislation.

Any tax due to the Scottish Parliament will be collected by the Inland Revenue. Normal arrangements would apply. Self-employed taxpayers would pay through their Self Assessment. Employees would pay through PAYE with their employers operating a special tax table which would reflect any varied rate set by the Scottish Parliament. The direct costs to the Government of establishing the mechanisms for tax variation in Scotland is estimated at around £10m. Running costs for the Government of collecting the tax are expected to be around £8m per annum, but may vary depending upon whether or not the Scottish Parliament chooses to vary the rate of tax.²⁶

²⁵ At present savings income is taxed at 20% - for lower and basic rate taxpayers - and 40% for higher rate taxpayers.

²⁶ The financial memorandum to the *Scotland Bill 1997/98* point out that if the Scottish Parliament should decide to use the tax-varying power, there would be consequential effects on eligibility to income-related benefits and on liabilities for child maintenance. These would involve extra public expenditure, estimated at up to £5 million a year, which would be met from the Scottish Consolidated Fund. If the full flexibility to vary tax is used there could be costs on appropriate personal pensions of the order of £4m, including set up costs.

The Scottish Parliament will meet the administration costs incurred by the Inland Revenue.

Collection through PAYE will also generate additional costs for employers. Their setting up costs are estimated to be around £50m (which could be phased) and running costs at around £6-£15m. Costs will vary from employer to employer. For illustrative purposes, an employer with 5 Scottish resident employees, (most cases in practice) would typically face setting-up costs in the range £50-£100. A larger firm, with 200 Scottish resident employees operating PAYE could expect set up costs in the range of £700-£1,400, around £5 per employee. Once the legislation enacting the tax-varying power is in place, the Government will publish a formal compliance cost assessment, following consultation with employers. If the Scottish Parliament exercises the tax-varying powers the resources available to it will be adjusted upwards or downwards by the appropriate amount.²⁷

During the debate on the White Paper, Tam Dalyell questioned the estimate that £450m could be raised by increasing the basic rate of income tax by 3p; the accountants Ernst & Young had suggested this estimate was calculated on the basis of earned income *and* saved income, even though the latter would not be subject to the Parliament's '3p basic rate power'. Mr Dewar explained that, "the exemption of savings income is almost de minimis. It does not raise very much, but an alternative arrangement would greatly complicate the system and cause the difficulties in relation to the financial services industry to which I have already referred. I am assured by the Inland Revenue that, on the basis of the 1997-98 figures, it is satisfied that £450 million would be the proper figure. I am talking about the use of the power at its maximum. There is a tendency to assume that it will always be used at its maximum, but that is not necessarily true. Indeed, the power may not be used at all in any given year."²⁸

²⁷ *Scotland's Parliament* Cm 3658 July 1997 pp 23-24

²⁸ HC Deb 31 July 1997 c.465

IV The Referendum Bill : wording the referendum

Legislation to provide for the two referendums on Scottish and Welsh devolution - the *Referendum (Scotland and Wales) Bill 1997/98* - was introduced in the Commons on 15 May 1997.²⁹ During its passage through the Lords, the Bill was amended with the intent that the second question of the Scottish referendum should ask if voters agreed that a "a Scottish parliament should have *income* tax-varying powers". In the event, the Commons disagreed with the amendment,³⁰ the Lords did not insist on it,³¹ and the original wording remained.³² ie, voters were asked if "a Scottish parliament should have tax-varying powers." In an interview with the *Scotsman* in August, Sir Bruce Pattullo, governor of the Bank of Scotland and a harsh critic of the Scottish Parliament's '3p basic rate powers', argued the Government's position on this question was wrong: "If the present Government mean what they say, I see no reason why they should not have accepted the Lords' amendment. I am very critical of the words income tax not appearing in the second question. I cannot see why the Government, if they were sincere, did not accept the Lords' amendment."³³

Lord Mackay of Ardbrecknish, Conservative party spokesman, first proposed this amendment to the wording of the second referendum question during the Bill's Committee Stage:

Turning to the purpose of my amendment, during the last debate in answer to the remarks of the noble and learned Lord, Lord Simon of Glaisdale, the Government Benches, both Front and Back, said that they were in no doubt that the tax was to be income tax and anybody who suspected that VAT or excise duty would be varied, or perhaps a property tax could be added to the existing council tax, or any other variation, was quite simply wrong and indulging in scare tactics. I would never do that, but I wonder why, if it is as clear cut as I am being told, the matter is not being put clearly. I cannot believe that my amendment is not perfect so far as the parliamentary draftsmen are concerned. Even I could not get the drafting of an amendment of this degree of simplicity wrong, and so I hope that the noble Lord might remember what he said earlier in the debate and do what he has assured the Committee is the Government's intention: that is, only to have variation on income tax. I see no difficulty at all in the noble Lord accepting my amendment. It would certainly be the most amazingly pleasurable start to my brief time in opposition if I were to have an amendment accepted by the Government at this early stage.³⁴

The amendment itself was agreed to during the Bill's Report stage,³⁵ when Lord Mackay put the argument in the following fashion:

It is a very small amendment; very, very small indeed. It simply means that I and my fellow Scots will look at a question which says, "I agree that a Scottish Parliament should have income tax-varying powers" or "I do not agree that a Scottish Parliament should have income tax-varying powers".

²⁹ The Bill received its Third Reading in the Commons on 4 June, before passing to the Lords.

³⁰ By 330 votes to 131 HC Deb 30 July 1997 c.419

³¹ HL Deb 31 July 1997 c.325

³² The *Referendum (Scotland and Wales) Act 1997* received the Royal Assent on 31 July.

³³ "From high on The Mound, a grenade tossed at Dewar", *Scotsman*, 22 August 1997

³⁴ HL Deb 1 July 1997 cc 172-173

³⁵ By 149 votes to 132 HL Deb 21 July 1997 c.1225

I know I should not be suspicious of the party opposite but I am afraid that the habits of a lifetime cannot be set aside easily. I am suspicious. I do not see any difficulty with adding the word "income". It makes clear on the face of the Bill and on the face of the ballot paper what Mr. Dewar has said, what Mr. McLeish has said and what the Scottish Constitutional Convention has said. So why do we not have a clear question? Why is the word left out?

The suspicious part of me says that it is left out because at some time in the future this Scottish Parliament may want to vary other taxes. The Government could then go back to this ballot paper and say, "The Scottish people agreed that the Scottish Parliament should have tax-varying powers. It did not specify income tax-varying powers". They may say - we shall come to it later - that the White Paper will say "income tax-varying powers". But that is not on the face of these questions either. The Government are not committed to sticking to the White Paper. Why is the word "income" not on the face of the Bill? Why are the promises which Ministers are making and the constitutional convention made about income tax being the tax that is to be varied not on the face of the Bill? ...

If the noble Lord does not accept my amendment, I can only conclude that the only reason why he will not accept it is in order to give this parliament, if it comes into being, a much more open-ended arrangement on taxation. I have little doubt that, for a year or two, if it happens, income tax is what will be varied, but then they will find that 3p. in the pound does not add up to much - £450 million in expenditure of £14 billion or £15 billion. Then they will say, "But we were not committed. No, you did not sign up, oh great Scottish public, just to income tax-varying. You signed up only to tax-varying. So perhaps we shall just vary a little more. We shall vary the other taxes". I hope that the noble Lord can set my suspicious mind at rest. However, short of accepting the amendment, I have to say to him that my suspicious mind will remain. I beg to move.³⁶

When the Commons considered the Lords Amendments, the Minister for Devolution, Henry McLeish, argued that rewording the second question in this way was unnecessary and misleading:

The key to this is to understand what the people of Scotland are asked to agree with. It is not some vague notion of an independent Scotland or some never-never promise of better things to come from the Conservative party; they will be asked whether they agree with the Government's proposals, and it says so on the ballot papers ... We have consistently argued that the questions to be put to the people should be at the level of principle, backed up by the detail contained in the White Paper. If we are to add the word "income", why not also include the 3p in the pound limit or a definition of who should pay the tax? We could keep adding qualifications until the questions on the ballot papers were half a page long. Similarly, we shall not ask on the ballot papers whether a Scottish Parliament should have powers over the health service in Scotland or over any other matters set out in the White Paper. I accept that a balance must be struck between keeping the questions simple and giving voters enough details so that they clearly know what they are voting for ...

It is important in this brief debate to look at schedule 1 to the original Referendums (Scotland and Wales) Bill to capture the fact that the questions must be seen in the context of the White Paper. I draw Opposition Members' attention to page 23 of the

³⁶ HL Deb 21 July 1997 c.1212

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White Paper, from paragraph 7.11 onwards, which deals with tax-varying powers. Paragraph 7.12 says:

"The Government propose that the tax varying power should operate on income tax, because it is broadly based and easy to administer. Income tax is relatively simple and easy to understand and has none of the difficulties associated with the other major tax bases: different rates of VAT on different sides of the border would cause practical problems and there would be specific difficulties with EU rules; corporation tax would place an unreasonable burden on companies operating in Scotland; National Insurance is inappropriate because of its direct link with the social security system; and council tax and non-domestic rates would over-burden the local government finance system and undermine the accountability of local government to its electorate."

... I submit that the questions on the ballot paper are linked to the White Paper. Naturally, the White Paper spells out in detail what we intend and do not intend ... The crucial point is that no one will put a cross on the ballot paper on 11 September without knowing in detail the implications of the Government's policies. We think that that is right and it is what the Scottish people want. On 11 September, they will be able to exercise a choice.³⁷

Speaking for the Government Lord Sewel summarised the issue when the Lords concurred with the Commons' view, and dropped the amendment:

We believe that our original wording is right. The tax-varying power is a sufficiently important aspect of the powers of the parliament to warrant a separate question, but it is not necessary to specify every aspect of the powers in question. That is done by and through the White Paper. To add the word "income" would create a false sense of precision, because it is limited. There are other factors that go beyond income in terms of the level of the income tax; what is and what is not covered in terms of savings and dividends; and who is liable to pay it. The referendum in Scotland will seek consent for the Government's proposals for a Scottish parliament with tax-varying powers. The people of Scotland will well understand what they are being asked to approve.³⁸

During the progress of the Bill in the Lords, one other issue arose in relation to tax varying powers which is worth noting; Lord Mackay of Ardbrecknish asked what the impact would be if a Scottish Parliament used their powers to *cut* the basic rate of income tax:

The question of varying taxation up or down is difficult because it is tied in with the difficult question of the consequences of that either for the Scottish government's expenditure or for Her Majesty's Treasury ... Let us assume for a moment that the tax-varying power means tax reducing. The Scottish parliament will say to the Inland Revenue that instead of collecting 23p in the pound, or whatever the standard rate will be once the Chancellor has presented his Budget tomorrow, those in Scotland will pay only 20p in the pound. The Inland Revenue will be down something like £450 million in their tax take ... I trust that the noble Lord, Lord Sewel, will wind up this debate. My question to him is this ... If this parliament decides to reduce tax by 3p in the pound in Scotland, will the Scottish block lose £450 million?³⁹

³⁷ HC Deb 30 July 1997 cc 409-411

³⁸ HL Deb 31 July 1997 c.319

³⁹ HL Deb 1 July 1997 cc 146-147

Lord Sewel answered Lord Mackay in the following way:

I wish to deal with a point made by the noble and learned Lord, Lord Simon, and, as expected, by the noble Lord, Lord Mackay of Ardbrecknish. It concerned the business of what would happen if the Scottish parliament increased or decreased income tax by 3p in the pound. Let us go over that. The noble Lord, Lord Mackay, is right and I do not see why there is any great mystery about it. It is not something that has been pulled out of a hat nor has it jumped out of a box. Clearly, if you reduce taxation, you have to pay for it. It is as simple as that. Reductions in expenditure must be made. We are not dealing with magic mirrors or something similar. It is a simple proposition.

Let us go over it. If the parliament decided to increase tax, the Inland Revenue would collect the extra tax, which would be paid over to the Scottish parliament by the UK Government. If the parliament decreased tax, then the Inland Revenue's overall tax take would be reduced. To reflect that, the overall level of resources passed to the Scottish parliament by way of block grant would be reduced accordingly. That is, if the Scottish parliament should decide to exercise that power. However, I must also stress that there is a world of difference between having a power and exercising that power through a policy. So let us not have another raft of scare stories that Scottish expenditure will be reduced because there will be a wish to reduce the level of taxation in Scotland.⁴⁰

⁴⁰ HL Deb 1 July 1997 c.150

V Discussion of the 'tartan tax' during the referendum campaign

Many of those critical of the current proposals for Scottish devolution have focused on the Scottish Parliament's '3p basic rate power', or, as critics have tended to label it, the 'tartan tax'. For example, in the case of the Conservative party, on 30 November 1995 the then Secretary of State for Scotland, Michael Forsyth, used the term 'tartan tax' when he responded to the Scottish Constitutional Convention's final report, *Scotland's Parliament, Scotland's Right*, published that month. On St Andrew's day, Mr Forsyth gave the third Richard Stewart Memorial Lecture, and he used the opportunity to criticise the SCC proposals, in particular the plan for tax varying powers - the 'tartan tax' - as well as the method of election proposed.⁴¹

In their 1997 election manifesto the Conservative party argued that one of the main reasons why plans by the Labour and Liberal Democratic parties for a Scottish Parliament should be rejected was that it would result in an "extra Tartan Tax imposed uniquely on Scotland": the tax "would make Scotland the highest taxed part of the United Kingdom and a less attractive place for companies to locate; penalising those on lower wages; taxing Scottish savings - including pensioners' hard-earned life savings - at a 15% higher rate; undermining the competitiveness of Scotland's financial institutions; creating inflationary pressures as workers seek higher wages to pay the extra tax; and creating an unprecedented differential tax regime within the United Kingdom - the precursor of separatism."⁴²

In the context of the Scottish referendum, 'Think Twice', the independent non-party group which was set up to spearhead a 'No No' campaign, concentrated on the arguments against a tax-varying power. When the campaign was launched on 7 August 1997, its chairman, Donald Findlay QC, explained, "The themes of the No No campaign will be clear and simple and linked to our campaign slogan which we are unveiling today - Think Twice ... or pay the Price. The first theme we will highlight is the price of higher taxes - not just income tax but higher council taxes and the new taxes such as those already being suggested by the President of COSLA⁴³ ... Our second theme is the price we all could pay for an Edinburgh parliament that creates jobs for the boys. If we allow this scheme to go ahead we will pay the price, not once but many times over."⁴⁴ In May Sir Bruce Pattullo, governor of the Bank of Scotland, suggested that a Scottish parliament would have to impose an additional sales tax,⁴⁵ and in a long interview with the *Scotsman* during the referendum campaign, the Governor argued that levying an extra 3p in the £ on income tax would endanger Scotland's competitive position, and implied Scots should vote Yes No:

"The board has never and will never say anything about the first question [of the referendum] ... The second question is a matter for employers, those in larger businesses and those who can see the macro-economic impact - they

⁴¹ Scottish Office press notice, *Secretary of State loosens controls on councils*, 30 November 1995

⁴² *Fighting for Scotland: The Scottish Conservative and Unionist Manifesto* April 1997 p.47

⁴³ Convention of Scottish Local Authorities

⁴⁴ Think Twice group press notice, *No no campaign launched with challenge to Dewar*, 7 August 1997

⁴⁵ "Scots bank governor raises fear of extra tax", *Financial Times*, 23 May 1997

should have something to say on the issue ... The voters of Scotland are thinking about the second question and have to think very carefully about it. Whether or not it is intended, there will come a point in time when a government will say that they received a mandate for tax-varying powers and one that was not just related to income tax. ... Someone has said that I am worrying needlessly because in Australia and Canada and the US you have different taxes but people live in a culture of different taxes. In the UK you are going to live in a region which has a different tax regime and it is going to stick out like a sore thumb. I do not want to dramatise the situation. It will be slow and corrosive ... I think that Yes, No is a perfectly patriotic situation. I would say Yes, No is a realistic patriot as against the romantic."⁴⁶

Even following the referendum vote Sir Bruce has continued to criticise this aspect of devolution, arguing the Parliament's tax varying powers are "mischievous and will come back to haunt us in due course."⁴⁷ The proposal for tax varying powers also came in for criticism from the British Retail Consortium,⁴⁸ and the Scottish branch of the CBI:

"The Confederation of British Industry in Scotland wants the government to drop the idea of giving its proposed Scottish parliament tax-raising powers. It argues that if the Scottish parliament was able to levy a surcharge on income tax, as the government proposes, it would put businesses in Scotland at a disadvantage because workers would demand higher pay ... Last week members of the CBI in Scotland told Mr Henry McLeish, the Scottish Office devolution minister, of their anxieties. The meeting was followed by a letter which said that if the government wanted to bring Scottish institutions under more democratic control this could be done 'without the granting of tax powers, with all their undoubted anomalies, costs and difficulties'. The income tax surcharge, the letter says, would be irksome for companies with employees in Scotland and England because residency rules would be complicated to establish. The costs of collection would be considerable and would be borne not only by companies and the Inland Revenue in Scotland, but throughout Britain. If the government does not drop the tax-raising powers - assuming they are approved in the referendum - the CBI in Scotland hopes to persuade it to exempt unincorporated businesses from the income tax surcharge. Unincorporated businesses pay income tax at the basic rate, rather than pay corporation tax, which Labour has said it would leave untouched in Scotland after devolution."⁴⁹

⁴⁶ "From high on The Mound, a grenade tossed at Dewar", *Scotsman*, 22 August 1997

⁴⁷ "Pattullo renews attack on potential Scottish tax", *Times*, 2 October 1997

⁴⁸ "Scots bank governor raises fear of extra tax", *Financial Times*, 23 May 1997

⁴⁹ "CBI Scotland opposes tax-raising powers plan", *Financial Times*, 9 June 1997

VI Arguments for and against tax-varying powers

The main concern opponents of the 'tartan tax' have expressed is that in granting a Scottish Parliament powers to vary the basic rate of income tax, it is 'inevitable' that the Parliament will use this power to increase tax. In his response to the White Paper Michael Ancram, Conservative party spokesman on constitutional affairs, argued the White Paper was damaging "because it will inevitably hit Scottish pockets. Powers to vary tax will be used, and it will be Scots who will pay."⁵⁰ Few can have sympathy with tax increases if they are seen in isolation, though there has been surprisingly little speculation about what an increase in Scottish income tax might fund. During the debate on the White Paper on 31 July 1997, the Secretary of State suggested that the tax varying power might "be used to deal with some special project or difficulty", but that he did "not expect that it would simply be added to the block-and-formula sum that is negotiated as a continuously available additional revenue support."⁵¹ Mr Dewar did not go into any more detail at the time, and the issue does not appear to have been discussed at any great length since then. There have been a number of substantive criticisms of the Parliament's '3p basic rate power': in particular, that it does nothing to ensure the Parliament's accountability to its electorate; that a differential in the basic rate of income tax will have a detrimental impact on the Scottish economy; and that charging a special Scottish supplementary income tax poses serious problems in terms of tax administration. These criticisms are looked at in turn.

A. Accountability

In a critique of the Scottish Constitutional Convention's 1995 report on devolution⁵² Arthur Midwinter and Murray McVicar, two academics at Strathclyde University, argued that the limited fiscal autonomy represented by the '3p basic rate power' would not promote more accountable government:

The autonomy of the Scottish parliament in fiscal terms would not be great. The 3p tax rule would provide less fiscal autonomy than that held by local authorities ... The Scottish parliament is proposed as a means of enhancing democratic accountability, but its fiscal dependence on Westminster and the inevitability of continuing arguments over spending needs will confuse accountability - as shown by the experience of local government in the 1980s.⁵³

In July 1996 the *Economist* made a similar case, emphasising that the amounts of money that the exercise of this power might raise were relatively small, just 3%, in comparison to the Scottish Office budget.⁵⁴ The point was made more recently Peter Riddell in the *Times*: "In

⁵⁰ HC Deb 24 July 1997 c.1045

⁵¹ HC Deb 31 July 1997 c.465

⁵² A.Midwinter & M.McVicar "The devolution proposals for Scotland: an assessment and critique", *Public Money and Management*, vol 16 no.4, October-December 1996 pp 13-20

⁵³ *op.cit.* p.16, p.19

⁵⁴ "Bleeding tartan taxpayers: Scottish devolution / Scotland's tartan tax", *The Economist*, 13 July 1996

most other countries, local and regional authorities can decide what taxes they want to levy, as well as rates of tax ... The problem about the 'tartan tax', like the council tax, is not that it is too large but that it is too small a proportion of total revenue. Talk of reviving local government and devolution is largely empty unless it is accompanied by a genuine relaxation of Treasury controls."⁵⁵

To some extent this criticism refers back to the argument as to whether devolution should be financed on an expenditure basis or a revenue basis. One might add that it rather misses the point: clearly it is important that the Scottish Parliament be accountable in its use of the 3p basic rate power - but the accountability of the Parliament as a whole is not reliant on its ability to raise revenue. Of course, this leaves the question of accountability open - but this is a subject at one remove, as it were, from the 'tartan tax'. David Heald, professor of accountancy at Aberdeen university, has pointed out that the argument undermines a second criticism - that a differential tax rate would undermine the Scottish economy: "Two mutually exclusive criticisms have been made of the tartan tax - that it would cripple the Scottish economy, and that it would raise so little money that it is an irrelevance."⁵⁶

B. Burden on Scottish business

A second criticism of the Scottish Parliament's '3p basic rate power' is that it would make Scottish business uncompetitive. The Scottish branch of the CBI has argued that Scottish workers would demand higher pay to compensate for any increase in income tax, and that these demands would increase business costs significantly.⁵⁷ In a piece during the referendum campaign, *Investors Chronicle* discussed the argument at some length:

Are Scotland's businessmen overreacting, or are their worries valid? They may have a point. Although companies and their shareholders are specifically protected from higher taxation, the main worry is that employees will try to compensate for higher income taxes by demanding more wages. Businessmen will then have to match their demands, so the argument runs, or risk watching their best employees move to England where the income taxes do not apply ... This argument must be kept in context, however. To see why, consider the following example. Average male earnings in Scotland are £18,900. If the parliament uses its powers to the full, average employees will pay an extra £323 a year in tax. Assume companies compensate them in full by paying them more. That equates to an increase in the wage bill of less than 2 per cent. Since most companies' wage bills are about three times profits, the move would reduce profitability by about 6 per cent. The example assumes the extra tax bill is passed on to employers in full. Experience suggests that's unlikely. The tax increases introduced by Norman Lamont in 1992 and 1993 had almost no effect on wage levels ... Another fear is that higher income taxes would make it harder for companies to retain young executives at the beginning of their careers, or would make it a struggle to attract managers to Scotland. "In recent years we have stopped net emigration from Scotland," says Donald Rutherford, lecturer in economics at Edinburgh University. "Extra taxes would make it less attractive to work here." But increased taxes are unlikely to spark a mass exodus. "We have much more trouble attracting and retaining staff in London," says a Scottish banker. "People don't move hundreds of miles because of a 3p in the pound increase in income tax." Higher wage and property costs in London are another reason why Scottish financial services companies — which account for a large chunk of the region's economy

⁵⁵ "Why Treasury needs to relax its rigid grip", *Times*, 17 December 1997

⁵⁶ "Tartan tax of 3p just 'crumbs from the Westminster table", *Guardian*, 9 September 1997

⁵⁷ "CBI Scotland opposes tax-raising powers plan", *Financial Times*, 9 June 1997

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— will be reluctant to make move to the South. "Even if wage costs rise, it will still be much cheaper to be in Charlotte Square than in the Square Mile," argues a fund manager.⁵⁸

The argument was also criticised recently by a think tank at Strathclyde University:

Claims by anti-devolution campaigners that an increase of 3p in Scottish income tax could damage Scotland's economy were dismissed as groundless yesterday by the Fraser of Allander Institute. Professor Brian Ashcroft, director of the economic think-tank based at Strathclyde University, said the tax-varying powers could have a positive economic impact. 'An increase in tax raises more revenue. If that is spent by the parliament and, providing that there is no reduction in the block grant, then there will be a demand stimulus in the Scottish economy, because when people have less take-home pay, their expenditure does not reduce exactly in proportion,' he said.⁵⁹

C. Difficulties in defining liability

One practical critique of the 'tartan tax' was given in a rather wry piece by a tax practitioner, published in January 1997. The author makes the important point that imposing the new tax on those resident in Scotland does pose some problems, especially in relation to the perceived fairness of the charge, for those who spend more than half their year south of the border, and so escape the tax. He concedes that in the United States, a federal income tax system operates alongside state taxes, but suggests the situation cannot be compared to one under a Scottish parliament:

The US has a system under which states charge tax in parallel with the federal system. Each state manages to collect its own tax but the overall structure is far from simple or cheap to administer. Taxpayers in one state pay tax in another if they do business there, subject to a minimum level of activity and determined by reference to property, payroll and receipts in the other state. A permanent residence test is applied if an individual has homes in two states and imperfect tax credits are given across state lines where income is subject to double tax. The US state arrangements are complex enough to apply but, most importantly, are workable because they sit within a countrywide framework where every neighbouring state collects its dues. In the UK, a new Labour Scottish tax would be working against the framework of there being a tax haven next door.⁶⁰

A much more detailed critique along the same lines was given in *Scotland on Sunday* by another member of the accountancy profession, part of which is reproduced below:

Being resident in Scotland would appear to be the obvious test of liability but will create legal headaches for the tax authorities at a time when they are striving to streamline the system. The new rules will, nevertheless, have to cater for all sorts of difficulties created by the ease with which people can move around the UK. The current system allows visitors to the UK to escape tax on their overseas income if they can prove they were not in the country for more than 183 days of the year. Presumably these rules would be adopted in Scotland - and there the problems would begin. How would they treat the self-employed builder whose family and home are in England, but who works and lives in Scotland from Monday to Thursday? Or someone who lives in Carlisle, but works for a Scottish employer on this side of the Border? Conversely, will someone who

⁵⁸ "Monster's powers more myth than reality", *Investor's Chronicle*, 5 September 1997

⁵⁹ "Tartan tax fears 'are groundless'", *Financial Times*, 2 October 1997

⁶⁰ "Tax shocks for Jocks", *The Independent*, 8 January 1997

regards Edinburgh as his home, but who works five days a week in London for a multinational company, be liable to the additional 3% levy? ...

Perhaps the easiest thing for those who draft the new legislation would be to use the existing UK tax rules and merely try to formulate a means of levying an additional rate of tax on the income which is deemed to be covered by the Scottish Parliament. But even this is complex. Detailed rules may be required to deal with situations where individuals are employed by a Scottish employer but where they work overseas. Another potential problem area is that of the self-employed, not all of whom have a fixed base from which they work. How will the new rules deal, say, with someone working in the construction industry who moves around the UK from contract to contract? Although certain classes of income have been put forward as being outside the scope of the tartan tax, others may not have been fully considered. For example, retirement pensions are regarded as earned income and are included within the PAYE system, so will we see the north of England becoming the place where Scottish workers retire? But for those still in work, the consequences could also be harsh. The remuneration packages of an increasing number of workers include a car, performance and annual bonuses, share options and healthcare. All of these have a value to the taxman and are regarded as income. If a whole new, expensive tax collection process is not to be set up, the existing Inland Revenue collection mechanism will presumably have to be extended to allow it to cope with a two-tier UK system of income tax.

We are now in the initial period of the new self-assessment regime for income tax. In order to bring self-assessment about many of the former complexities of UK income tax law have been simplified. To create a new raft of legislation in the form of the tartan tax would appear to fly in the face of that process. Nevertheless, a collection mechanism of some sort has to be established and it has to work fairly and cost-effectively. For some 50 years now, the PAYE system has been of tremendous importance and value to the UK tax authorities. It is an efficient, fair collection system which imposes only a limited cost burden on the Inland Revenue, leaving employers to shoulder the bulk of the costs involved in implementing the collection process. It also provides central government with an excellent cash flow by requiring employers to account promptly, on a monthly basis, for the tax deducted. It is fair to assume that the PAYE system will be used, because this largely transfers the burden of collection and compliance to companies. Fine from the Scottish Parliament's point of view, but hard for business to swallow.⁶¹

On this last point, the White Paper acknowledges that collection of additional income tax from Scottish taxpayers through PAYE will generate costs for employers:

[Employers'] setting up costs are estimated to be around £50m (which could be phased) and running costs at around £6-£15m ... An employer with 5 Scottish resident employees, (most cases in practice) would typically face setting-up costs in the range £50-£100. A larger firm, with 200 Scottish resident employees operating PAYE could expect set up costs in the range of £700-£1,400, around £5 per employee.⁶²

Although proponents of devolution might well acknowledge the practical problems in the use of the '3p basic rate power', it seems likely that they would argue that these problems are relatively minor, when one considers the Government's aim: a fair and just settlement for Scotland within the framework of the UK; and a Parliament to strengthen democratic control and make government more accountable to the people of Scotland.

⁶¹ "Hidden costs of being Scottish", *Scotland on Sunday*, 16 February 1997

⁶² *Scotland's Parliament Cm 3658 July 1997 p.24*

VII The *Scotland Bill 1997-98* : Clauses 69-75 and Clause 98

The tax-varying powers of the Scottish Parliament are dealt with by clauses 69-75 of the Bill. For further details Members are referred to Notes on Clauses, which are to be published at the time of the Bill's Second Reading.

Clauses 69 & 70 allow for the Parliament to pass a "tax-varying resolution": clause 69 describes the purpose of such a resolution; clause 70 sets out the procedure for its being made. The basic rate of income tax for Scottish taxpayers may be increased or decreased from the rate determined by the UK Parliament by up to 3p in the £, provided the Scottish Parliament has passed a resolution to this effect. Any change must be in whole or half pence - and can be reversed by a subsequent resolution (clause 69(1) & (2)). Income from savings and distributions are exempt from these provisions (clause 69(3)). Although the rates of income tax for any year are established under the Finance Act, each year the tax authorities are empowered to collect income tax prior to the Act receiving Royal Assent under a 'PCTA' resolution (named after the legislation which provides for these arrangements: the *Provisional Collection of Taxes Act 1968*). Clause 69(4) & (5) makes it clear that any change made to the basic rate by the Scottish Parliament prior to the passage of the Finance Act for that year, refer to the rate that is specified in the relevant 'PCTA' resolution.

A tax-varying resolution may relate to only a single year of assessment beginning after, but no more than 12 months after, the resolution has been made (clause 70(1) & (2)). Of course the UK Parliament may determine the basic rate for a given year after that year has commenced. A tax-varying resolution may still have effect for that year provided it is passed within a month of this determination (clause 70(3), (4) & (7)). The Scottish Parliament cannot pass a tax-varying resolution in relation to any year before 2000-01 (clause 70(6)).

Standing orders shall ensure that only a member of the Scottish Executive may move a motion for a tax-varying resolution (clause 70(5)). This last provision has been criticised by the Scottish National Party, but the Secretary of State was quoted by the *Scotsman* as noting that this is a practice that was accepted by most legislatures in Europe. "Budgets and financial issues were matters for the government of the day. Opposition parties did not normally have a power to introduce budgets. Once the executive put forward its plan, it was up to opposition parties to argue about how these should be amended. 'There is nothing sinister or restricted in that sense,' Mr Dewar said."⁶³

Clause 71 defines the expression "Scottish taxpayer" - those to whom a separate Scottish basic rate will apply. A person is a Scottish taxpayer for a particular year if he is resident in the UK for tax purposes, and Scotland is the part of the UK with which he has the closest connection (clause 71(1)). Generally speaking, the latter criterion is satisfied by a person who has his principal UK home in Scotland or spends more of the year in Scotland than elsewhere in the UK (clause 71(2), (3) & (4)). Members of the Scottish Parliament, and those representing Scottish constituencies at the UK and European and Parliaments, are also

⁶³ "Bill spells out how extra income will be protected", *Scotsman*, 19 December 1997

covered (clause 71(2)(c). If a taxpayer has more than one place of residence in the UK, provided their main place of residence is in Scotland, they will be counted as a Scottish taxpayer (clause 71(5)).

Clause 72 requires the UK Treasury to propose amendments to the Parliament's tax-varying power in the event of any changes in the UK tax structure which would impact significantly on this power. The Secretary of State referred to this procedure when the White Paper was debated on 31 July 1997: "if the Parliament's power to raise the £450 million - which will be index-linked to preserve its real value - were eroded at some hypothetical future date by changes in the United Kingdom tax structure, an alternative base with the same sort of impact in terms of distribution would be provided by the Treasury."⁶⁴ One change which would have this effect would be if the UK Parliament cut the basic rate of income tax significantly. Indeed, in his pre-Budget statement on 25 November 1997 the Chancellor, Gordon Brown, confirmed the Government's intent that "in order to maximise the rewards from work, a 10p starting rate of tax ... will be introduced when it is prudent to do so."⁶⁵

If the Treasury considers that a proposed change in the tax structure will have a significant effect on the "practical extent" of the Parliament's tax-varying powers, it is required to make a statement to the House on this matter, and propose any amendments to those powers that it considers necessary (clause 72(1) & (2)). The "practical extent" of these powers refers to the maximum amount the Parliament could have altered income tax by a tax-varying resolution (clause 72(6)). Essentially the Parliament's ability to raise, or forgo, up to £450m from 2000-2001 is to be preserved - making due allowance for inflation since 1997-98 (clause 72(4)). Any amendments will relate only to income tax, and cannot affect the exemption of savings and dividends (clause 72(3) & (7)). The potential impact on taxpayers of these powers cannot be significantly different to their potential impact in earlier years (clause 72(5)).

This may be thought to be a controversial clause. In an editorial the *Scotsman* suggested that "no attempt was made [at the time of the referendum campaign] to correct the impression left with many voters that the parliament would have unfettered, if limited, taxation powers ... It transpires that the Treasury is to retain control over the tax-levying powers of the Scottish Parliament ... more power is to be reserved at Westminster, and greater restraints placed on Edinburgh, than we were led to believe."⁶⁶ In an interview with the paper, the Secretary of State explained that if changes were made which destroyed the Scottish parliament's tax base, then the Treasury had to offer an alternative which would provide largely the same fiscal and distributional impact for income tax in Scotland. "It is not something we expect to happen in the immediate future; it may never happen," he said. Mr Dewar said that it would clearly be unwise if the Government did not make provision to offer an alternative. The Scottish parliament would need to decide whether to trigger the new tax base, which would depend on political and economic calculations in Scottish terms. He added: "There is no hidden trick in here. This is a fairly transparent piece of drafting which reflects exactly what we have said

⁶⁴ HC Deb 31 July 1997 c.465

⁶⁵ HC Deb 25 November 1997 c.776

⁶⁶ "Labour dilutes devolution", *Scotsman*, 13 December 1997

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and what we have repeatedly made clear in the referendum campaign and through the White Paper."⁶⁷

Clauses 73 and 74 set out the arrangements for any transfers of funds between the Scottish Parliament and the Inland Revenue, following the passage of a tax-varying resolution. If the basic rate of income tax has been increased for Scottish taxpayers, the Revenue is required to pay into the Scottish Consolidated Fund an amount equal to the estimated yield of this increase from Scottish taxpayers (clause 73). If the Scottish Parliament cuts the basic rate, the Revenue is to receive a payment equal to the consequent shortfall in their receipts, made out of the Scottish Consolidated Fund (clause 74). The Board of the Inland Revenue is required to make arrangements for estimating the sums involved, for revising any estimates, and for paying - or receiving - the correct amounts of money (clause 73(4)-(6) and clause 74(4) - (6)).

Clause 75 allows the Treasury to make secondary legislation to take account of the Scottish Parliament's tax-varying power in particular, it may by order exclude the effect of any tax-varying resolution in relation to, for example a particular part of the income tax code. It may also by order postpone the effect of a resolution on the operation of the PAYE system until a date after the first day of the tax year, as is possible now with respect to income tax changes generally.

Clause 98 deals with the interaction between the tax-varying power and the social security system, to ensure clarity and certainty in the calculation of benefits, though the sums at stake are relatively small. The clause gives the Secretary of State powers to make regulations for two purposes: first, to establish rules for determining who is a Scottish taxpayer for social security purposes (clause 98(1)); second, to allow the Department to determine benefits throughout a given year, even when the basic rate of income tax for Scottish taxpayers is changed during that year (clause 98(2)).

Social security benefits are calculated on a weekly basis. This poses practical problems where the benefit calculation is based on an assessment of the claimant's net income. As mentioned, for tax purposes a residence test is to be applied when determining whether someone is a Scottish taxpayer or not - but it may be only at the *end* of a given year when one can say, definitively, what the result of this test would be for an individual.⁶⁸ The Department intends to use the general rule that, for benefit purposes, claimants with addresses in Scotland will be taken to be Scottish taxpayers. A similar problem arises from the fact that the Scottish Parliament may amend the basic rate of tax during the year of assessment itself. To avoid confusion, the Department is to issue an order, clarifying what the basic rate will be taken to be over any year of assessment in benefit calculations for Scottish taxpayers.

⁶⁷ "Bill spells out how extra income will be protected", Scotsman, 19 December 1997

⁶⁸ As income tax is calculated on a cumulative basis, this does not pose any problems for the tax system.