The Role of Income Tax in Scotland's Budget
Response from the Low Incomes Tax Reform Group (LITRG)

1 Executive Summary

1.1 LITRG welcomes the publication of the Scottish Government discussion paper: The Role of Income Tax in Scotland's Budget, and its aims of opening up debate on the use of Scotland's income tax powers and generally raising awareness of the role of tax in society.

1.2 We think that it is hugely helpful that the discussion paper not only reiterates the Scottish Government's commitment to the Adam Smith canons for taxation, but also frames the debate by setting out the four key tests it will apply when setting income tax policy.

1.3 We wish to emphasise the importance of striking a balance between various competing aims, which include raising more revenues for Scotland, protecting lower earners and ensuring the tax system is simple to understand and easy to operate.

1.4 In this document we consider some of the possible interactions between the Scottish income tax system and the reserved tax, social security and welfare benefits systems, including universal credit (UC), National Insurance contributions (NIC) and Marriage Allowance. We also point out that to an extent these interactions are inevitable, so it is crucially important to consider how any adverse effects might be minimised, in particular for those on low incomes, who are least able to cope with them.

2 About Us

2.1 The LITRG is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes.

CHARTERED INSTITUTE OF TAXATION
1st Floor, Artillery House, 11-19 Artillery Row,
London, SW1P 1RT

REGISTERED AS A CHARITY NO 1037771

Tel: +44 (0)20 7340 0550
Fax: +44 (0)20 7340 0559
E-mail: litrg@ciot.org.uk
www.litrg.org.uk

UK REPRESENTATIVE BODY ON THE
CONFEDERATION FISCALE EUROPEENNE

Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.

2.2 LITRG works extensively with HM Revenue & Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.

2.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3 Introduction

3.1 LITRG welcomes the publication of the Scottish Government discussion paper: The Role of Income Tax in Scotland's Budget[1] and the opportunity to participate in a roundtable discussion on 13 November.

3.2 The paper is a thoughtful and readable contribution to the debate on the use of income tax powers and does a number of important things, which include explaining the nature of the Scottish Parliament's income tax powers and their limitations, exploring possible spending policies, exploring the effects of the income tax proposals of the parties in the Scottish Parliament and setting out four alternative approaches and their potential implications.

3.3 In addition to confirming the Scottish Government's commitment to a Scottish tax system underpinned by Adam Smith's tax canons,[2] the paper sets out four key tests that the Scottish Government will take into account when drawing up their income tax policy.[3] It is helpful that the Scottish Government has set out the parameters for its approach to income tax policy in this manner, as it helps to frame the debate.

3.4 We are non-party political and do not recommend a particular policy approach from those proposals and approaches set out in the discussion paper. What we can do though is to comment on proposals and point out any issues. In this response, we highlight and go into more detail in a few areas that are touched on briefly in the discussion paper, as we believe

---

[1] http://www.gov.scot/Publications/2017/11/5307

[2] Certainty, convenience, efficiency and proportionality as set out in "An Inquiry into the Nature and Causes of the Wealth of Nations" (1776).

[3] These are a revenue test, a progressivity test, the protecting lower earners test and the economic growth test. P. 11 ff. "The Role of Income Tax in Scotland's Budget" (2017): http://www.gov.scot/Publications/2017/11/5307.

these could cause particular problems for those on low incomes. In doing so, we wish to emphasise the importance of striking a sensible balance between various competing aims, which include raising more revenues for Scotland, protecting lower earners and ensuring the tax system is simple to understand and easy to operate.

4 Awareness and Education

4.1 There are a number of stakeholders that need to be made aware of the income tax powers devolved to Scotland and/or the policy decisions, including those, such as employers, payroll operators and pension providers, who may need to amend or update processes, software and systems. Although there is a much greater awareness now than previously among Scottish taxpayers of the fact that Scotland has some income tax powers, this is not as widespread as we would hope. Where there is awareness, this is often not sufficient to provide the taxpayer with a clear understanding of the scope of the Scottish Parliament's powers or how this affects them.

4.2 Naturally, we would expect Scottish Government to liaise with HMRC and the Department for Work and Pensions (DWP) as appropriate to ensure that their systems are ready in time to deal with changes.

4.3 In order to raise awareness among Scottish taxpayers generally, it is crucially important that various media are used, including newspapers, radio, television and social media. We would strongly suggest that the use of advertisements is considered, rather than just using articles, interviews, etc.

4.4 Once the rates and bands are known, LITRG will publicise these on our website.[4] Inevitably, however, the Scottish Government has a broader reach within Scotland than our charity. We recommend in this regard that the Scottish Government publishes a further brief document, which could draw on some of the content from the discussion paper. This new document could rehearse the points about the scope of the Scottish Parliament's powers over income tax, explain the new policy and as with the discussion paper, use tables and diagrams to illustrate some of the effects and possible interactions. This would be with a view to not only raising awareness, but actually increasing understanding of income tax in Scotland and educating Scottish taxpayers.

5 Complexity

5.1 The current basic structure of income tax on non-savings and non-dividend income for Scottish taxpayers, with three bands and rates, is fairly straightforward. One only needs to consider more than one rate of tax if taxable income exceeds the higher rate threshold of

[4] https://www.litrg.org.uk/tax-guides/tax-basics/what-scottish-income-tax

£43,000 (in 2017/18). Of the around 2.5 million income taxpayers in Scotland in 2018/19, only around 366,000 pay tax at the higher or additional rate of tax, and therefore have to consider more than one rate and band of Scottish income tax.[5] So for 85% of Scottish taxpayers, it is currently very straightforward to calculate one's own tax on earnings.

5.2 Some of the proposals put forward by different parties and approaches 2, 3 and 4 introduce additional bands and rates. We agree that additional bands and rates may increase the progressivity of a tax; however, this must be balanced against other considerations. For example, under approach 4, an individual with income of £25,000, which is not significantly above the expected median income of Scottish taxpayers for 2018/19 of £24,000, will pay £21 less in income tax than they would under approach 1.[6] However, in order for them to work out and understand their own tax liability, they would need to use three different bands and rates. Under approach 1, they would only need to use one band and rate. The question of whether the reduction in tax liability is worth it in comparison to the potential for confusion in working out one's own tax liability is even more acute if the individual is a UC or means-tested benefits claimant (see paragraph 6 below).

5.3 A further consideration in relation to cutting tax liabilities for those on lower incomes generally, such as through approach 4, is how effective this is in targeting those who actually require assistance. Moreover, a lowering of the rate affects all taxpayers and requires higher rates or lower thresholds to recoup the revenues further up the income distribution. Furthermore, it will not benefit those with incomes so low (below the Personal Allowance) that they do not currently pay any income tax. There are around 2 million (out of 4.5 million total) adults in Scotland who have income below the Personal Allowance.[7] It may be therefore that it is more efficient and effective to have a structure that retains the simplicity of one band and rate for those on lower incomes, while using other devolved powers, such as those over elements of social security, to target help where it is most needed.

5.4 Moreover, a change to the structure of income tax in Scotland, through the addition of more bands, will make the Pay As You Earn (PAYE) system more complex for HMRC to administer, which would affect the majority of Scottish taxpayers. There is also a risk that they will not

[5] Section 3.2, The Scottish income tax base, in "The Role of Income Tax in Scotland's Budget" (2017): http://www.gov.scot/Publications/2017/11/5307

[6] See Appendix 1. Under approach 1, an individual with non-savings and non-dividend income of £25,000 has an income tax liability of £2,630. Under approach 4, however, an individual with income of £25,000 has an income tax liability of only £2,609.

[7] Section 3.2, The Scottish income tax base, in "The Role of Income Tax in Scotland's Budget" (2017): http://www.gov.scot/Publications/2017/11/5307

be able to programme their self assessment software correctly to deal with all groups of Scottish taxpayers.[8]

6 Interactions with Universal Credit and tax credits

6.1 Changes to tax rates and bands have a particular impact on UC claimants, due to the fact that when determining entitlement to UC, the DWP takes into account net earned income, i.e. after tax income. By contrast, tax credits (TC) entitlement is determined by reference to gross income, meaning that tax rate and band changes do not directly affect a claimant's credits, although they may be worse or better off by comparison to a UC claimant, depending on the particular change. It should be noted that neither UC nor TC are taxable.

6.2 Inevitably, in such a brief document, we have been unable to explore all possible variables, and the examples given are simplistic and illustrative only. It should be noted that there are a number of difficulties involved in exploring these areas. For example, income tax is for the most part based on an individual's personal financial circumstances, whereas UC and TC take into account a household's financial circumstances. Moreover, there are a number of other, non-financial variables that can affect UC and TC awards. There are also issues such as the DWP's use of notional income tax and NIC in certain circumstances, which we do not consider here.

6.3 Taking UC first: the basic position is that an existing UC claimant's UC award will increase if their net income after tax decreases and will decrease if their net income after tax increases. An individual's income for UC is split into earned and unearned income. Unearned income, which includes items such as pensions, is taken into account in full on a gross basis and reduces the UC award £ for £. A Taper Rate is applied to net earned income, designed so that an individual sees the benefit of increasing their earnings overall. Due to the Taper Rate, which is currently 63%, they will only see 37% of each change to their net earned income.

6.4 ***Example (NB for ease of illustration annual figures have been used and NIC is ignored)***

6.4.1 An individual has gross taxable earned income of £15,000, which is £14,370 after tax.[9] They receive UC of £6,000 annually. So, their total take home income is £20,370 (£14,370 + £6,000). If approach 4 is adopted, the individual pays less tax, meaning their net after tax income is £14,402. Their net income has increased by £32 (£14,402 - £14,370). This means that their UC award is reduced, according to the Taper Rate, by 63% for each additional £1 of income. So, their UC award is reduced by £20 (£32 x 63%) to £5,980. Their total take home income is therefore £20,382 (£14,402 + £5,980). This is only £12 more than their original

[8] HMRC exceptionally made an amendment mid-tax year to their self assessment online filing system in October 2017, to correct errors in calculating the tax liability of certain taxpayers with savings and/or dividend income. This was due to the complexity of the personal savings allowance and dividend allowance, introduced in April 2016.

[9] See Appendix 2.

take home income. They have only benefited from the £32 tax reduction to the tune of £12 (37%).

6.5 It should be noted that broadly if a UC claimant's tax liability increases, reducing their net income, their UC award will increase – this change will again be subject to the 63% Taper Rate. So, a £32 decrease in net income would result in a £20 increase in the individual's UC award, such that the net decrease on their overall income is only £12. Given the Scottish Government's four tests for income tax policy, including protecting lower earners, it is likely that only UC claimants on incomes above the median will face tax increases – if they do, the Taper Rate should temper these to some extent. As mentioned earlier, the Taper Rate does not apply to unearned income, such as pension income, and because the gross figure is used for unearned income, any tax changes applying to that aspect of an individual's income will not be felt in the UC award.

6.6 Looking at TC: changes to tax rates and bands do not affect the level of TC award, since it is calculated by reference to gross income.

6.7 ***Example (NB for ease of illustration annual figures have been used and NIC is ignored)***

6.7.1 An individual has gross taxable earned income of £15,000, which is £14,370 after tax.[10] They receive TC of £6,000 annually. So their total take home income is £20,370 (£14,370 + £6,000). If approach 4 is adopted, the individual pays less tax, meaning their net after tax income is £14,402. Their net income has increased by £32 (£14,402 - £14,370). This has no effect on their TC award, which remains at £6,000. Their total take home income is therefore £20,402 (£14,402 + £6,000). This is £32 more than their original take home income. Unlike the UC claimant, they benefit to the full extent of the reduction in tax liability.

6.8 However, if the TC claimant's tax liability increases, reducing their net income, their TC award will remain unchanged. So, they would feel the full effect of, say, a £32 decrease in net income after tax – their TC award would not increase at all to compensate for this.

6.9 Although we have not considered other means-tested benefits, such as income-based Employment and Support Allowance and Income Support, in this document, since these are also often determined by reference to net income, similar interactions are likely to arise. In particular, we would suggest that the Scottish Government consider interactions with Pension Credit and Council Tax Reduction.

6.10 To an extent, interactions with UC, TC, other means-tested benefits, NIC (see paragraph 6 below) and reserved aspects of the UK tax system are inevitable. We would suggest therefore that the important points are to be aware of such interactions and their effects, and to minimise the impact on those least able to cope with them, particularly those on low incomes.

[10] See Appendix 2.

6.11 In considering the impact of a particular approach on individual taxpayers (as opposed to the other considerations facing the Scottish Government, such as the impact on HMRC and the Scottish finances), it is necessary not only to use a financial lens, but also to take stock of how complex the system will be. One of our concerns is that the tax system should be as simple (and fair) as possible, easy to navigate, and that it should be possible for taxpayers to understand their tax liabilities.

6.12 We note that an approach that makes changes only to the current higher rate and additional rate bands is more likely to minimise these interactions; it is unlikely to eliminate them completely, as there will be some claimants with higher levels of income.

7 Interactions with National Insurance Contributions

7.1 There are differing views about NIC, and whether it is a 'tax' or not. This document does not concern itself with the nature of NIC. Rather, we draw attention to the fact that regardless of its nature, NIC reduces the net take home income of those who pay it, such as employees and the self-employed. The discussion paper refers to the interaction of income tax and NIC, and draws attention to the fact that the higher rate threshold for income tax for Scottish taxpayers is no longer aligned with the upper earnings limit for NIC. This means that Scottish taxpayers face a marginal overall tax and NIC rate of 52% (40% income tax plus 12% NIC) on employment income between the higher rate threshold of £43,000 and the upper earnings limit of £45,000 in 2017/18.[11]

7.2 In a sense the same problem applies further down the income distribution, in that non-taxpayers whose income is between the NIC primary earnings threshold (PET) and the income tax Personal Allowance pay NIC at 12%, then a combined rate of 12% NIC plus 20% tax – 32% in total – applies as soon as the personal allowance is exhausted.[12] This is a UK-wide problem caused by the non-alignment of the PET and the Personal Allowance. But the effect of combining NIC rates with income tax rates shows a different pattern from simply taking account of income tax rates alone – in Scotland 12%, rising to 32%, rising to 52%, then falling to 42%.

7.3 The system is still progressive overall, but less so than if one took income tax rates on their own, and the 52% rate is an interruption to the progressive flow. We note that approaches 1 to 4 do not exacerbate this situation. In relation to those on lower incomes, we note that none of the approaches creates additional problems in this regard.[13]

---

[11] See Appendix 1.

[12] See Appendix 1.

[13] See Appendix 1.

8 Other Issues

8.1 We note that under section 80C of the Scotland Act 1998, as amended by the Scotland Act 2016, the Scottish Parliament must set a "Scottish basic rate, and any other rates".[14] If extra bands and rates are added to the Scottish income tax system, the determination of which is the basic rate will need to be considered carefully. This is because the basic rate is used when determining certain reliefs, such as relief on pension contributions.[15]

8.2 In addition, certain reliefs are only available to those who are not higher rate or additional rate taxpayers, most notably Marriage Allowance.[16] The recipient of the Marriage Allowance must not be taxable at a rate other than the basic rate, the default basic rate, the savings basic rate, the dividend nil rate, the Scottish basic rate, the dividend ordinary rate, the savings nil rate or the starting rate for savings.

8.3 So, for example, under approach 4, if the 19% band represented the basic rate band, then couples where the higher earning partner has income of more than £15,000 would not be able to benefit from the Marriage Allowance. Whereas currently, couples where the higher earning partner has income up to £43,000 can benefit from this relief.[17]

LITRG
24 November 2017

---

[14] http://www.legislation.gov.uk/ukpga/2016/11/part/2/crossheading/income-tax

[15] Cf. section 192 Finance Act 2004: http://www.legislation.gov.uk/ukpga/2004/12/part/4/chapter/4/crossheading/members-contributions

[16] Cf. Section 55B of Income Tax Act 2007, as inserted by Finance Act 2014, and amended by Finance Act 2016 and Statutory Instrument 2015/1810: http://www.legislation.gov.uk/ukpga/2014/26/section/11/enacted. Under Marriage Allowance, one partner may transfer 10% of their Personal Allowance to their partner (£1,150 in 2017/18). The recipient partner benefits from this as a tax reducer, at their basic rate of tax – this means they can deducted £230 (20% x £1,150) from their tax bill.

[17] The income levels are a simplification – according to the legislation, the key factor is the rate of tax paid, not the level of income. So, in theory, a Scottish taxpayer with income of more than £43,000 could currently be a recipient of Marriage Allowance from their partner, provided they do not pay tax at a higher rate. This could be achieved by, for example, making sufficient pension contributions to extend the basic rate band to cover all income.