

**Inquiry into the Devolution of Further Fiscal Powers – Call for Evidence
Response from the Low Incomes Tax Reform Group (LITRG)**

1 Executive Summary

- 1.1 LITRG welcomes the opportunity to respond to the Finance Committee of the Scottish Parliament’s call for evidence in respect of their inquiry examining the options for the devolution of further financial powers to the Scottish Parliament and the impact of such powers on the block grant.
- 1.2 We are apolitical and do not have views on the levels of taxation – these are matters for elected representatives. We also do not offer views on whether a particular power should be devolved. Rather we seek to identify practical issues that may arise.
- 1.3 As befits our remit, we are concerned to ensure that the tax, tax credits and welfare systems deliver their aims in an efficient and straightforward way – imposing the least administrative burdens on the taxpayer.

2 About Us

- 2.1 The Low Incomes Tax Reform Group (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. 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 In recent years LITRG has engaged with the Scottish Government concerning the setting up of Revenue Scotland, including the development of the Revenue Scotland website, and has responded to consultations on the Revenue Scotland and Tax Powers Act 2014. We have been involved in discussions on issues relating to the Scottish Rate of Income Tax and have given evidence to the Finance Committee of the Scottish Parliament on tax management issues relating to low income individuals.
- 2.4 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 General principles

- 3.1 LITRG is an initiative of the CIOT; we support the CIOT's separate submission. Our response focuses on points of concern and those fiscal powers with direct relevance for the low income individual.
- 3.2 It is clear that the key area for further devolution of powers will be taxation. We believe that devolution of tax and welfare powers should be based on sound principles. It should take into account the nature of current taxes and the implications of devolving each tax to Scotland. It is necessary to take a holistic view of the tax and welfare systems; for example, it is necessary to consider local as well as national taxes and the interactions between benefits and taxes.
- 3.3 There are three main options for further devolution, which can probably be used in combination:
- Devolution of power over a tax to Scotland;
 - Assignment of an appropriate share of total UK tax revenues of a particular tax;
 - Giving the Scottish Parliament the power to vary the rate of a tax, which HMRC collects, passing the relevant revenues to the Scottish Government.
- 3.4 We think it is important for there to be a consensus on the principles that should inform the decision as to which further powers should be devolved to the Scottish Parliament.
- 3.5 One of the principles that the UK Government set out during the passage of the Scotland Act 2012 was that any proposal should not be to the detriment of other parts of the UK. This principle should be borne in mind, as should the interaction of any proposal with the Barnett formula. In conjunction with this, consideration should perhaps be given to a form of equalisation, to ensure that the whole of the UK shares burdens and benefits, in a manner which is beneficial to both Scotland and the rest of the UK.
- 3.6 The Scottish Government has committed itself to a tax system that has regard to Adam Smith's four principles: certainty; burden proportionate to the ability to pay; convenience; efficiency of collection. In terms of making a decision as to which taxes, or parts of taxes, should be devolved, we think that principles akin to those of Adam Smith should be borne in mind:

- 3.6.1 **Certainty** – it should be clear what is being devolved, and the implications for individuals and businesses. In addition, this information should be clearly communicated to taxpayers;
- 3.6.2 **Fairness** – the tax should be structured fairly, and in addition, whichever body is responsible for operation of the tax should ensure that administration and collection is carried out equitably;
- 3.6.3 **Efficiency** – the devolved tax should be efficient to operate. One question to ask could be whether the devolution passes real powers to Scotland and meets a real need to adjust the tax to suit local circumstances. Another issue to consider is whether devolution of a particular tax may result in greater costs and administrative burdens for the tax authorities. We recommend that a cost-benefits analysis is carried out;
- 3.6.4 **Stability** – the tax should not be subject to regular adjustment – if the system or tax is not stable, this will undermine certainty and damage confidence in the tax system. Future changes in tax and benefits policy in the rest of the UK might affect the Scottish system – consideration should be given as to how such interactions will be dealt with;
- 3.6.5 **Simplicity** – the devolved tax should be easy to understand and deal with for the taxpayer and simple to operate for the tax authority;
- 3.6.6 **Consultation** – there should be consultation with taxpayers concerning the details – this will ensure they understand the impact and burden of the proposals and will help to ensure that practical issues are identified and addressed prior to implementation.
- 3.7 Inevitably, further devolution of taxation powers will cause some uncertainty, disruption and extra work for taxpayers, employers, agents and tax authorities. It is important that all parties work together to overcome challenges. A key remedy will be communications – we think that a communications strategy should be developed as part of the planning for the devolved taxes.
- 3.8 We note that the Scottish Government takes a Digital First approach to tax. We recognise that a digital solution for the operation and collection of taxes can be efficient. We advocate, however, that there should always be an easily accessible alternative for the taxpayer. Low income taxpayers may not have digital access; those with certain disabilities may not be able to use computers or digital channels; older taxpayers may not have the training or familiarity with computers or the internet to be able to use them accurately or efficiently; taxpayers living in certain parts of Scotland have only intermittent or no internet access.¹ In particular, we refer you to the recent UK First-tier tribunal tax case *LH Bishop Electrical Co Ltd*,² in which three taxpayers won their appeal against HMRC's requirement that they file VAT returns online on the grounds that such a requirement breached their human rights.
- 3.9 Lessons could be learned from countries such as Canada and Germany, which manage devolved taxes, for example, federal, state and local. They do this by having common calculations and one return/collection point. The authorities allocate the tax revenues. Equally, useful lessons of how not to approach the issue can be taken by observing the

¹ Digital Exclusion – a LITRG report (May 2012): <http://www.litrg.org.uk/reports/2012/dig-excl>

² *LH Bishop Electrical Co Ltd A F Sheldon (t/a Aztec Distributors) v Revenue & Customs* [2013] UKFTT 522 (TC) (30 September 2013) TC02910.

position in Australia – there are many minor taxes, which may well be inefficient and ineffective and place burdens on taxpayers.

- 3.10 LITRG would welcome the opportunity to assist in ensuring that whatever taxes are devolved to Scotland, the resulting tax system is effective and efficient. We would also wish to assist in ensuring that system interacts well with the benefits system. As communications will be key, we would be happy to assist in this area, with the aim of ensuring that messages reach all affected taxpayers.

4 Further financial powers, constraints and interactions

- 4.1 In principle most, if not all taxes currently collected by Westminster can be devolved³ – although there are some exceptions to this, such as Value Added Tax (VAT), due to EU rules.

Income tax

- 4.2 Income tax is being devolved to the Scottish Parliament to some extent through the Scottish Rate of Income Tax (SRIT), which will apply from 6 April 2016. The planning process has been ongoing for some time, meaning that employers, payroll software houses, HMRC and pension companies are reasonably well-prepared. If further powers in relation to income tax are devolved, such as the ability to alter the deductions, allowances and reliefs available and all the rates, burdens will increase significantly. It is likely that many more individuals will have to complete tax returns.
- 4.3 There are practical issues with a partially devolved tax, as will be the case from 6 April 2016 (subject to changes following the Smith Commission). Currently, the SRIT will apply to earned income and rental income. This means that employment and self-employment income will be subject both to a devolved tax (SRIT) and a reserved tax (UK income tax) and reserved National Insurance contributions (NIC). Directors of small companies may receive much of their income in the form of dividends, which will be subject to reserved UK income tax only. Issues may arise in terms of the order of taxation of income and the order in which personal allowances are used.⁴ Similar issues may arise with loss relief, repayments of tax and decisions as to which part of a tax liability has been settled when only partly paid.
- 4.4 In terms of income tax for businesses, there is a risk of adding to burdens for business. For example, if the power to alter the rules for computation of profits for tax purposes is devolved, this could result in businesses that operate across the UK having to prepare separate accounts and profit computations.

³ Currently Council Tax and Non-domestic Rates are devolved. From 1 April 2015 there will be a Scottish Landfill Tax and a Scottish Land and Buildings Transaction Tax; from 6 April 2016 there will be a Scottish Rate of Income Tax for non-savings and non-dividend income.

⁴ By way of example: An individual with £10,000 of bank interest and £10,000 of rental income will be able to set their £10,000 personal allowance against their income, leaving only £10,000 taxable. Is this £10,000 subject only to UK income tax (if the savings income) or both UK income tax and the SRIT, if it is viewed as the rental income or a mixture of both types of income?

- 4.5 Possible options for income tax include devolving all powers, including how to determine the tax base;⁵ devolving power to determine tax bands and rates; or devolving power to determine tax rates only. Full devolution of income tax could raise an issue in terms of whether current double tax treaties would continue to apply. Changes in the tax base through changes to personal allowances could have unexpected consequential effects, for example, if the link between the automatic enrolment threshold for workplace pensions and the personal allowance for income tax is maintained, changing the personal allowance in Scotland could result in a misalignment with that threshold, departing from the desired simplicity of maintaining the link between the two.
- 4.6 Ease of administration is a key objective of the tax system. Therefore it is important to take account of the capabilities of both taxpayers and their advisers to cope with multiple changes. Scottish taxpayers will generally also be UK taxpayers and will need to deal with two tax authorities.
- 4.7 Whilst it is unlikely that the problems mentioned above are insurmountable, there will clearly be administrative costs and a great deal of work involved to overcome them. We therefore think that it would be advisable to retain a common tax base.

Income tax, tax credits and benefits

- 4.8 It is important not to consider income tax in isolation; in particular, interactions with tax credits and benefits can have a significant impact on the living standards of low income individuals.
- 4.9 If income tax powers are devolved to the Scottish Parliament, but powers over welfare benefits and tax credits are reserved, changes in income tax rates could have unintended consequences. The interaction between income tax and benefits will have to be considered.
- 4.10 For example, a reduction in the rate of income tax may not be the most effective way of helping people on very low incomes because of the interaction with means-tested benefits that are based on net income, as they will not benefit from their increased net earnings level to the same extent as someone not in receipt of a means-tested benefit. Indeed, when considered alongside additional ‘passported’ benefits, such as free school meals, help with NHS costs etc., the combination of increased net pay and reduced means-tested benefit could lift an individual outside the entitlement threshold which passports them to these additional aspects of support. Universal credit (UC), for example, will be reduced if after-tax income increases. This may mean that the reduction in income tax rates is not to the advantage of the individual claimant/taxpayer or Scotland, as consumption does not increase as expected.
- 4.11 Equally, an increase in income tax rates might be problematic in other ways – it would possibly lead to an increase in tax revenues; individuals might find they have to pay more tax, but they would be compensated at least partially by an increase in benefits, if those benefits are related to after-tax income. This however might not meet one of the principles

⁵ The SNP have previously indicated that they oppose the UK Government’s transferable tax allowance for married couples (Scotland’s Future – 2013). Devolution of powers to determine the tax base (including allowances) for income tax could lead to this allowance being treated differently in Scotland – in turn, this could lead to disputes, if one member of a couple is a Scottish taxpayer and the other is not.

of devolution, as it would be the UK Parliament facing an increased welfare benefits bill as a result of the Scottish Parliament's policy.

- 4.12 Another option would be the introduction of a local income tax. Low income individuals might not have to pay such a tax; an issue might arise with benefits that are centrally-funded however, as the lack of a tax liability might preclude those individuals from receiving the benefit.

Housing benefit

- 4.13 Housing benefit (HB) has been suggested for devolution, since housing, social care and health are devolved. An issue that arises is that HB is one of the benefits to be encompassed by UC. If the UK Government roll UC out throughout the UK, it is likely to be extremely complex to unpick HB to allow devolution of this one element. In terms of keeping things simple for benefits claimants, this would not necessarily be the best option.

Attendance allowance

- 4.14 Attendance allowance (AA) has been suggested for devolution, since it is linked to social personal care, which is an area already devolved. Currently, AA is paid along with the state pension. If AA were devolved, not only would communications with elderly and vulnerable people be paramount, but it would also be important to make sure that such payments continued seamlessly, to ensure that affected individuals continue to be able to meet their bills as expected.

Additional benefits

- 4.15 In terms of benefits generally, rather than devolving all powers or a proportion of powers, another option would be to devolve powers to supplement UK benefits. For example, this would mean that UC would apply in Scotland, but if the Scottish Parliament deemed it appropriate, it could create a supplementary benefit to be provided in specific circumstances. For cost efficiency, the starting point might be the UC income assessment, but there could be further considerations, such as the Scottish Government's assessment of local needs.

Welfare system

- 4.16 The welfare system in the UK is already very complex, with many interconnected areas. It might be difficult to ensure that the Scottish Parliament bears the cost or reaps the reward of its decisions and this could hinder the accountability and transparency aimed for through devolution. This will be particularly the case if piecemeal devolution occurs.
- 4.17 Piecemeal devolution would also be likely to disadvantage the most vulnerable low income individuals in society, who would likely find the many interactions confusing. The aim should be to ensure that whatever devolution occurs, the resulting system is as simple as possible for the claimant to negotiate.

Other taxes

- 4.18 The CIOT have commented in detail on a wide range of taxes. We endorse those comments.

5 Implications

- 5.1 A key consideration with devolution will be which tax authority should have responsibility for administering a particular devolved tax. It is important to take account of the capabilities of Revenue Scotland and HMRC to cope with multiple changes. In order to ensure successful devolution, it will be necessary to secure the necessary expertise and capacity, and consider how any extra burdens for the tax authority will be paid for. While some taxes may be capable of devolution, the costs of collection may militate against devolution.
- 5.2 Revenue Scotland will start to operate two devolved taxes from 1 April 2015. Common sense suggests that the new tax authority may need time to establish itself and build its resources and expertise. Further responsibilities for Revenue Scotland may result in a need to increase staff numbers substantially and to develop new IT systems swiftly. On the other hand, further responsibilities for HMRC may need to take into account the likely future capacity of that organisation. In simple terms, more devolution of taxes will necessitate more resources to administer them, either at Revenue Scotland or at HMRC, or possibly both.
- 5.3 We also think that further devolution requires time for implementation, to allow for proper consultation, sound drafting of legislation and development of tax administration.
- 5.4 Further devolution could result in low income taxpayers having to deal with more than one tax authority. This could be confusing, in particular for unrepresented taxpayers. To reduce the likelihood of confusion or duplication of work, it will be necessary for Revenue Scotland and HMRC to co-ordinate their activity. By way of example, the two tax authorities should liaise where a taxpayer in both jurisdictions is subject to an enquiry – it would be unfair on the taxpayer (and costly for the tax authorities) if they undergo an enquiry by Revenue Scotland and then face a further enquiry by HMRC.
- 5.5 In terms of the block grant, this is not an area in which we have expertise. We do however think that it is important that the formula for reduction is transparent. It is also essential that there is co-ordination between the UK and Scottish Governments in relation to taxes.