

POLICY INSTITUTE

Scotland's Hidden Tax Cutting Powers

**How Scotland can cut taxes to boost growth – within
the existing devolution settlement**

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Synopsis

“Say no to the tartan tax,” cried the anti-devolutionists of 1997 and 1999. They lost the vote, but won the war. The Scottish Parliament was given only limited tax raising powers. They have never been used. But, the scope for *cutting* taxes in Scotland is vastly greater. The Scottish Executive should use these powers to unleash economic growth and create a new magnet for investment and enterprise in Scotland – a Tartan Tiger economy.

POLICY INSTITUTE

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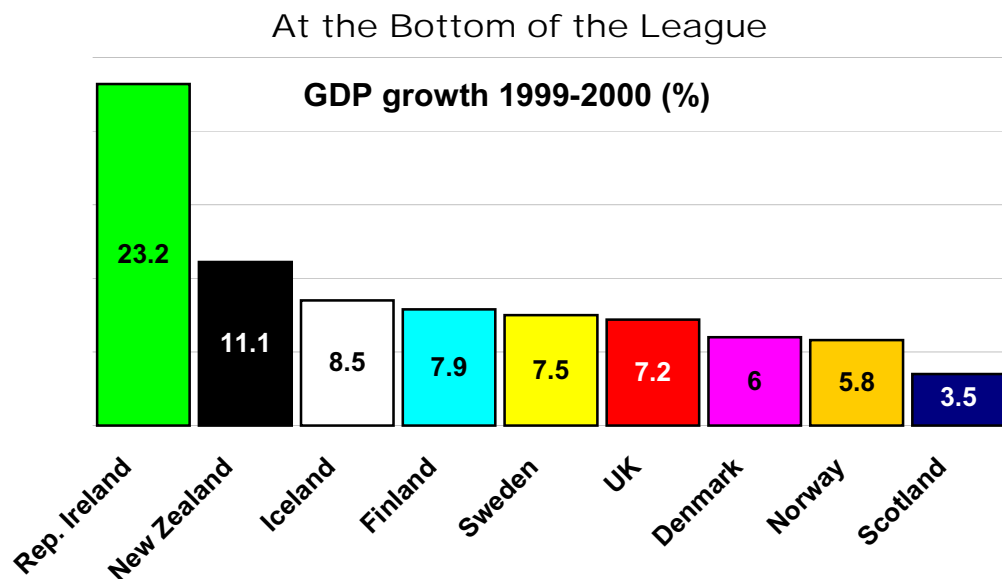
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Setting our sights

Scotland's economic growth rate continues to trail behind the UK average and that of many other OECD countries (see graph below). Many excuses have been offered. One is that the UK population is growing faster than Scotland's – so the gap in output *per head* is not as severe as the headline growth difference. Another is that Scotland is 'over'-reliant on manufacturing, which has suffered disproportionately in the global economy¹.

These points may have some validity. But it is surely time to set our sights higher than excuses for relative underperformance. Political leaders have a duty to allow the conditions for much faster growth. This would lift thousands out of poverty and re-establish Scotland at the forefront of global growth and economic dynamism.

The potential for higher growth is here. One need only look at countries similar in population, geography and society to our own to see what is possible:



Source: OECD and Scottish Executive statistics

There are many conditions for high growth. These include a well-educated workforce, light government regulation, efficient transport infrastructure and utilities, a productive public sector, and open, competitive markets². The Scottish Executive has a contribution to make on all of these. However, **this paper concentrates on the need and potential for lowering taxes.**

¹ A good example of this approach can be found in the June '03 Quarterly Economic Commentary by the Fraser of Allander Institute.

² The Heritage Foundation publishes an annual 'Index of Economic Freedom' which examines the correlation between economic growth and government policies based on open markets, secure property rights and the rule of law. See <http://www.heritage.org/research/features/index/>.

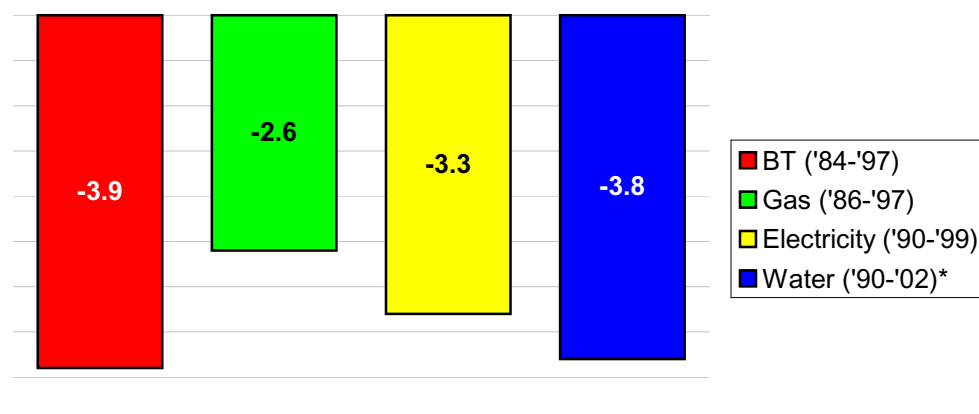
Taxes and growth

There is no one mathematical formula which links the level of taxation in a country with the rate of economic growth. So numerous are the conditions and factors that affect growth that no two countries are sufficiently similar for comparisons on tax levels alone to be made.

However, the overwhelming evidence of logic and experience tells us that cutting taxes boosts growth. It seems obvious that switching resources from the state to the more productive private sector would increase overall productivity and growth. This is particularly the case in Scotland which has such a wasteful state sector – public spending, at 47 per cent of GDP³, is at the top of the OECD range, while health and educational outcomes remain near the bottom. The UK government does not measure public sector productivity. But the efficiency gains achieved by the privatised industries give some indication of the gap between the public and private sectors. The following table shows how prices have fallen in the telecoms, gas and electricity industries since privatisation. In the water sector, overall prices have increased to cope with new investment requirements, but the table shows the average annual price reduction in the privatised English water industry compared to its nationalised Scottish counterpart. In the case of gas and electricity, the rate of price reduction has increased since full competition was introduced.

The private sector is more efficient

Annual % Charge Reductions Since Privatisation



Source: *The UK's Privatisation Experiment*, David Parker Sep '03. 'Flushed with Anger' Peter Jones, *Scottish Business Insider* Sep '03. The Water figure shows the relative falls in English water charges compared to the state owned Scottish water companies.

³ Scottish Executive Statistics. Some projections show that public spending will shortly overtake that in Sweden at the top of the OECD table.

The point is that, whether you are returning assets (in the case of privatisation) or cash (in the form of tax cut) to private sector control, productivity is bound to increase in response to the competition, choice and profit incentives which exist in the private sector.

Three further considerations should be taken into account about tax cuts.

1) The effect of reducing taxes is greater when tax rates are already high. This is because the same tax cut multiplies the net figure by a greater amount. So if a tax is reduced by 10 per cent from 90 per cent to 80 per cent, the net amount doubles, whereas if it is reduced from 20 per cent to 10 per cent it only increases by an eighth⁴.

2) Certain taxes are more damaging and distortive of economic behaviour than others. Indirect taxes, such as VAT, do not change consumer behaviour as much as direct ones such as income tax, for example. Economists who favour tax cuts point to capital taxes, taxes on investment income and inheritance tax as favourites for reduction or outright abolition⁵.

3) Targeted tax cuts can be more effective when they provide relative advantages compared to neighbouring jurisdictions. The Irish Republic seems to have used this to great effect by setting very low corporation taxes to attract inward investment. These are cited repeatedly as a prime cause of the Irish Republic's high economic growth rate of recent years. The Irish Development Agency's Colm Donlon said that low corporation tax "is the absolute essential. We have a commitment ... that it's 12.5 per cent until 2025. That's what's promoted internationally and that's a very stable environment for investors examining Ireland as a location for future investment." ⁶

Cutting taxes in Scotland

The Scottish Executive is perceived to have very limited scope for cutting tax. In reality the opposite is the case – it has considerable powers to reduce the burden of taxation. These can be divided into two types – formal and informal. Its formal powers are those which allow it to vary actual rates of tax. Informally, it can also conduct policy which has the effect of lowering taxation.

⁴ For a more in depth explanation of this theory and the benefits of tax competition see 'Tax Reform and Simplification', the Journal of The Institute of Economic Affairs, Vol 23 No1, March 2003.

⁵ See for example 'Euthanasia for Death Duties', by Barry Bracewell-Milnes, IEA 2002. The author says that Inheritance Tax not only costs 50p for every £1 it raises, but "does immense economic damage and is perverse and couterproductive for its own ostensible purposes, egalitarian or otherwise".

⁶ Irish Examiner, 30/12/02.

Formal tax powers

The Scottish Executive has formal power over two types of taxation: income tax and non-domestic rates. The Executive was granted the power to vary the basic rate of income tax by 3p in the pound. Put another way, it could cut the basic rate of income tax (22 per cent) by 13.6 per cent. This would cost the Executive (and save the taxpayer) some £700m based on current income tax receipts⁷. Reducing income tax in this way would lower business wage costs and increase the private spending power of employees.

The Executive also has power over non-domestic rates. The Scottish Parliament sets the multiplier by which local authorities calculate the rate due on business property. Reducing the multiplier to zero would save business in Scotland some £1.7bn⁸. This measure would be of particular benefit to small businesses, for whom 13 per cent of overheads are business rates (compared to 3 per cent for large business⁹).

Informal tax powers

In addition to the power to vary these two taxes, the Scottish Executive has potentially vast powers to affect the overall level of tax paid through the exercise of its powers. One way is by altering Scots law to change the tax status of various entities and individuals, thus removing them from or placing them in different categories of taxation. The status of commercial partnerships in Scotland may be amenable to legislation of this kind. These measures require detailed legal examination beyond the scope of this paper. However, there is another way the Executive can reduce the effect of taxation which goes even further in scope.

The Scottish Executive is responsible for £17.6bn of public expenditure, or 48 per cent of total government expenditure in Scotland¹⁰. It is allowed to set policy as to how this money is spent with almost complete freedom. It could therefore decide to return this money to taxpayers as cash, vouchers or grants instead of spending it, effectively **reducing the burden of taxation in Scotland by half**.

How might this power be used in practice? For reasons discussed more fully later, not to mention political considerations, the Executive may wish to start modestly. However, for illustrative

⁷ If income tax payers were incentivised to produce / declare more income by the cut, overall tax receipts to the UK Treasury would not fall by as much as £700m – the so-called Laffer effect. This reduced effect would presumably be passed through to the Scottish Executive's Departmental Expenditure Limit.

⁸ Figures for non-domestic rate receipts from 'Government Expenditure & Revenue in Scotland 2000-1', published by the Scottish Executive 20/01/03.

⁹ According to evidence given by the Federation of Small Business to the Scottish Parliament in 2000.

¹⁰ 'Government Expenditure & Revenue in Scotland 2000-1', published by the Scottish Executive 20/01/03.

purposes we outline a radical way to provide tax incentives to encourage leading FTSE-100 companies to move to Scotland. This programme, the '**FTSE Flit**', would be controversial. There are, of course many other ways in which the Executive could encourage business. But it draws on a recent precedent for a tax rebating strategy. It is set out in the colour panel at the end of this paper.

Corporation tax receipts from Scottish companies amount to some £2.6bn¹¹. Were the Executive to expand a tax cutting programme over time to emulate fully the Irish Republic by effectively reducing rates to 10 per cent across the board, it would need to rebate Scottish businesses about £1.7bn.

Let us assume that a tax cutting Executive wished to combine this strategy with the two 'formal' tax powers at its disposal. This would imply a total tax reduction of £4.0bn, or 6 per cent of Scottish non-oil GDP – equivalent to £800 a year for every man, woman and child in Scotland. Such a reduction in the burden of taxation in Scotland would provide a powerful fillip to the economy and growth rate. Major companies would be incentivised to locate or stay in Scotland. Small business costs would be dramatically reduced, encouraging growth, investment and business start-ups. Employment costs would fall, leading to a reduction in unemployment. Private sector spending and investment would receive a big boost – improving productivity. Scotland would then be on its way to becoming the next tiger economy – a tartan tiger.

But, but...

This paper demonstrates the considerable scope that exists for the Scottish Executive to lower the burden of taxation. A number of objections are commonly made to this kind of approach, and more may be added to the concept of returning money to taxpayers in the form of cash, vouchers or grants. We recognise that there may be UK and EU policy impediments, but we do not think that they are insurmountable.

Where will the money come from?

This paper uses as an example the figure £4bn as the kind of tax reduction the Executive could achieve if it began to use its powers fully. This equates to 11 per cent of total government expenditure in Scotland. More importantly, it represents fully 23 per cent of the Scottish Departmental Expenditure Limit (DEL), that portion of government spending controlled by the Executive.

¹¹ 'Government Expenditure & Revenue in Scotland 2000/1' published by the Scottish Executive 20/01/03.

A common question to those who propose tax reductions is ‘where will you cut spending to finance this cut?’ A few observations are pertinent. First, while the UK Treasury would be the prime beneficiary of any Laffer curve effect (see note 6), some of this would feed through to the Executive whose financial bargaining position would be strengthened. Second, the ability of the Scottish Executive to borrow is limited¹², so any reduction in taxes would need to be matched almost immediately by spending reductions.

However, as we have seen, public spending in Scotland is already some 23 per cent higher in Scotland than it is in England, while public services do not have notably superior outcomes. Were policies devised, therefore, to improve productivity in those parts of the state sector controlled by the Executive, spending could be reduced to English levels while outcomes improved. Reducing the DEL by 23 per cent in this way would yield the £4bn figure required to finance the tax reduction, though clearly this would require a phased approach. A further obvious source of saving would be a reduction in the role and scope of Scottish Enterprise. Either way, a more gradual approach would be required, characterised by more modest initiatives such as that outlined below.

Undermining the ‘Barnett Formula’

Some commentators argue that, were the Scottish Executive to use even just its formal powers to cut tax, this would undermine the existing constitutional and funding arrangements from which Scotland benefits. The notorious Barnett formula maintains public spending per head of 23 per cent higher in Scotland than in England. Many English politicians are resentful of this fact, and might argue that if Scotland felt able to spend the DEL on tax cuts, it clearly did not require the extra money.

But any arguments for higher public spending in Scotland should remain unaffected by how the Executive decides to spend its share of the money, whether in tax cuts or service provision. Besides, those who complain about the current arrangements may have a valid point that needs to be addressed at some stage anyway.

Legal and constitutional considerations

It should not be beyond the wit of legal man to find ways of returning taxpayers money in Scotland. However, there may be legal challenges to the Scottish Executive refunding Scottish taxpayers in the form of grants, vouchers or cash. Particularly, certain types of grant might be taxable under Inland Revenue

¹² The Scotland Act 1998 stipulates that the Executive can borrow up to £500 million from the Treasury to cover short term cash flow movements (Part III section 67).

rules. Take the scenario where the Executive decides to rebate companies two thirds of their corporation tax payment to reduce the effective rate to 10 per cent. The Inland Revenue might treat this rebate as a taxable receipt, reducing its net effect by the applicable rate of corporation tax. The Scottish Executive would in effect be returning a proportion of its DEL to the Treasury in a seemingly wasteful circularity.

However, to imagine this scenario is to imagine one where constitutional conflict is an inevitable consequence of Scotland conducting its own policies under the devolved settlement. In reality, there should be no reason why the UK Treasury and Inland Revenue should not allow such rebates to go untaxed in a similar way to reliefs for church building repairs (see box). Would they risk constitutional crisis and calls for fiscal autonomy to prevent this? Even if they did, a Scottish 'rebate' strategy would lessen the public spending difference between the two countries, and the case for more fiscal powers would be strengthened.

The FTSE flit – a recipe for growth

The churches may not be the first role models that come to mind when thinking of ways to revive Scotland's economy. But they benefit from a scheme that could be a template for economic recovery. This scheme provides an interesting precedent for how the Executive might return money to taxpayers.

As owners of a portfolio of historic – and often listed – buildings, all the faiths in Britain face an ongoing struggle to limit their repair and restoration bills. Whatever the cost of repairs, they are inflated by the requirement to pay VAT. The Church of England has the most significant commitment. It pays about £250 million a year on maintenance and repairs. Of this total £44 (17.5 per cent) million goes in VAT. The Church of Scotland and others have similar proportionate outlays.

After a successful and persistent lobbying campaign the Treasury decided to act. Like the Scottish Parliament it is unable formally to vary the churches' VAT rate (because of European Union rules). Instead it introduced a grant scheme to rebate 12.5 per cent of the churches' VAT bills on repairs. For the Church of England this represents a tax saving of some £30m a year.

The scheme suits everyone. The Treasury can afford to forego the income, while the churches cannot. EU rules are met. Rolling repairs, put off because of the cost of tax, can be reinstated, saving the need for bigger repairs at a later date. Traditional crafts and workmanship are encouraged, small businesses prosper, and apprentices and trainees kept on. Spend to save, as some might say.

This is a relevant example for the Scottish Economy. It is the principle of the grant scheme that offers a solution to one aspect of Scotland's

economic malaise. It is a truth universally acknowledged that one of the causes of Scotland's current position is the small number of corporate HQs located here. Various solutions have been offered. The most recent has been to follow the Republic of Ireland, the 'Celtic Tiger', and lower corporate taxes to make it advantageous for companies to move here. At face value this approach requires amendment of the Scotland Act to give the Scottish Executive powers now reserved to the Treasury. While "fiscal autonomy" may be a positive next step in the evolution of the devolved settlement, it is a long term goal, not an immediate win. There is a much more achievable solution, one that could be delivered by the Scottish Executive within a year. All it requires is for us to follow the example set by the churches in their repairs grant scheme.

How might this be applied in reality? The Scottish Executive has set each of Scotland's cities a challenge. Tell us what your vision is for your city in the coming decade. The first responses have been worthy if limited. Edinburgh wants to be a bit more European. Glasgow wants to have a bit more money. How much more ambitious – for all Scotland's cities – to aspire to attract ten FTSE 100 corporate HQs in the next decade? Admittedly, the decision to relocate is not purely driven by tax. But all the other levers are in the hands of the Scottish Executive – transport, education, health, environment and culture. It doesn't take a huge leap of the imagination to contemplate the following chain of events.

In a speech to the annual conference of the Association of Fund Managers held in Edinburgh, the First Minister announces that Scottish Ministers intend to launch a ten year plan with the objective of bringing ten FTSE 100 company HQs to Scotland. He admits that his "Fresh Talent" scheme – to attract Scotland's brightest exiles – has been too tame in its ambition. "For too long," says the First Minister, "our brightest and best have left Scotland and taken their talents south. Today, I am announcing my intention to bring the best of our diaspora home, by making Scotland the natural place to live long and prosper in the United Kingdom. We will create a tangible 'smart, successful Scotland' by bringing the finest company headquarters north of the Border – and reclaiming our rightful place as the enterprise hub of Europe."

The Scottish Executive then publishes its "10 by 10" strategy. At the heart of the policy is an acknowledgement that by offering fiscal incentives for companies to locate their HQs in Scotland, government – local and national – will benefit more from the economic growth that results than it will forego in taxation. Taking a leaf out of the Treasury's book, the Executive announces that it is setting up a "10 by 10" fund to offset a proportion of any relocating company's corporate taxes. EU State Aids rules are sidestepped by applying the fund to the whole of Scotland. An Executive spokesman indicates that the First Minister and deputy First Minister would both prefer that the Scottish Executive had powers over corporate tax, but the grant scheme was a good interim step.

The “10 by 10” fund is simple in concept, within the powers granted to the Executive by the Scotland Act, and achievable from the Executive’s budget. In a separate statement to Parliament, the Finance Minister indicates that initial funding will come partly from Scottish Enterprise’s budget, partly from end year flexibility. In addition, Scotland’s cities would be expected to seek additional funding through public-private partnerships as part of the new powers of well-being introduced in earlier local government reform.

In tandem with the “10 by 10” fund, and following on from its “Better Cities” review carried out in 2003, the Executive challenges Scotland’s cities to pick the company they most want to move to them, and to draw up plans for their relocation.

Edinburgh targets Lloyds TSB as a natural complement to the presence of the Royal Bank and HBOS. Glasgow chooses GlaxoSmithKline as part of its drive to become one of Europe’s healthiest cities by 2010. Aberdeen, looking the oil and gas sector, sets its sights on Centrica. Dundee, anxious to restore its links with jam making, indicates that it would like Associated British Foods to relocate to the Tay estuary. Inverness – keen to become the most wired city in Britain – opts for MMO2, and Stirling, playing to its heritage as one of the most fought over places in Britain, looks to invite BAe Systems to move to Bannockburn.

At the formal launch of the “10 by 10” strategy, the First Minister announces that a group of Scottish headquartered companies has formed a joint venture to build a high-speed rail link from Glasgow to Edinburgh. The syndicate will fund the project by a form of land value capture. “This is a step-change in private-public partnerships”, says the First Minister, “When we are bold we are at our best.”

Conclusion

The purpose of this paper is not to advocate constitutional change (however desirable). It is to make the case for a dynamic Scottish economy spurred by lower taxes. It shows that the Executive and Parliament have considerable formal and informal tax cutting powers, and advocates that they should use them. Such a course of action need not result in constitutional upheaval. But if the settled will of the Scottish Parliament to lower taxes was obstructed at the UK level on whatever grounds – then it might be a good moment to consider realigning the Scotland Act in any case.

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