# The Principles of Scottish Taxation


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## The call for evidence

1. The call for evidence to which this paper responds is as follows:

2. *As a result of the devolution of taxation powers via the Scotland Act 2012 and 2016 the structure of devolved public finance will shift from a focus upon expenditure to consideration of revenue-raising and the principles which should underpin the Scottish approach to taxation. Reflecting this shift in the nature of devolved public finance, the Finance Committee wishes to initiate a debate on the approach which should be followed in developing a Scottish approach to taxation. Notably, the Scottish Government has stated that four principles will underpin its approach to taxation policy. These four principles are that taxation policy should:*

    a. *Be proportionate to the ability to pay;*
    b. *Provide certainty to the taxpayer;*
    c. *Provide convenience / ease of payment, and;*
    d. *Be efficient.*

3. *Accordingly, the Finance Committee has agreed to undertake an Inquiry on a Scottish approach to taxation.*

4. In addition this paper comments on two additional questions the Committee is apparently considering, added since the original call was made and which are dealt with in this paper after the original call has been considered. These are:

    a. Should Scotland establish its own income tax rates?
    b. Should Scotland have its own laws on incorporation?

## Introduction

5. I note that it has been suggested that Scottish taxation be built on the foundations of:

    a. Proportionality;
    b. Certainty;
    c. Convenience;
    d. Efficiency.

6. These ideas are, of course, familiar. Adam Smith might have used the term equity rather than proportionality; otherwise these come straight from The Wealth of Nations.

7. I have no desire to question the authority of a great Scottish moral philosopher but it is fair to note that Smith might be a little surprised at the scope and range of taxes to which his principles are now being applied. He would, for example, have been unfamiliar with the idea of:

a. Income tax;
b. National insurance;
c. VAT;
d. Corporation tax;
e. Capital gains tax;
f. Many other modern levies and charges.

8. If the tax system has changed out of all recognition since Smith wrote so too might some other issues as well. Modern principles of tax need to reflect:

    a. Modern taxation theory;
    b. The role tax now plays in economic policy;
    c. The social and economic priorities of the society that imposes the charge;

9. I suggest that this means that the proposed principles may prove to be insufficient as the foundation for a Scottish tax policy.

**Tax and spend, or spend and tax?**

10. To build appropriate foundations for a tax system the role of tax in the economy and wider society has to be properly understood. It is my suggestion that this is rarely the case. Just as the Bank of England had to say that the role of banking had been almost wholly misunderstood by economists and was incorrectly represented in almost all economics tax books in 2014[1], so too is tax widely misunderstood.

11. It is widely thought that tax is necessary to pay for government provided services. It has, however, recently been realised that this is not true. This is because all government services can *in principle* be paid for either by printing money or by QE operations (which amount to much the same thing).

12. The reality is, of course, that no government would want to pay for all government services this way. That is because the result would undoubtedly be rampant inflation. This though does not, however, change the principle: that principle is that all government services can be paid for without taxation.

13. What is more, if the proverbial 'chicken and egg' question of which comes first with regard to government spending or taxation is asked then it must be government spending. If government did not spend first then none of the currency it insists be used to pay the taxes it demands be paid would actually exist. The fact that much of the money in question has no tangible existence and is only in an electronic bank accounts

[1] http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q102.pdf

does not change this conclusion: those banks and the accounts that they operate only exist under a licence granted by the government.

14. Appreciation of this fact demands a whole reappraisal of the role of tax In the economy, just as happened when the Bank of England said in 2014 that the awareness that it was lending that created bank deposits and not savings that permitted lending demanded a whole reappraisal of the role of money in the economy.

## The six reasons for taxation

15. If tax is not required to pay for government provided services it must have other reasons for existing. There are six of them.

16. **Reclaiming the money the government has spent into the economy.** It may appear that tax revenue is being used to pay for government services supplied but that is not true: the service comes first and the tax comes second. Tax reclaims the money spent to prevent inflation. The amount reclaimed is that which is considered sufficient to leave the desired rate of inflation in the economy. Because we may well want some inflation - and that usually requires that more money be created than be reclaimed by tax - balanced budgets are usually a bad idea for the macro-economy because they deny the economy the cash it needs to function in a mildly inflationary environment.

17. **Ratifying the value of money.** Because a government requires that tax be paid using the currency that it creates, and uses when undertaking its own spending, that currency has for all practical purposes to be used in the economy for which it is responsible, assuming that tax forms a significant part of people's liabilities. Tax does, therefore, give a currency its value in exchange and as a result provide control of an economy to the government that charges it.

18. **Reorganising the economy.** Fiscal and monetary policy are the two fundamental tools available to a government to manage its economy, assuming it has its own currency. As the previous analysis has shown, money creation and taxation are the flip side of each other. Tax is then an integral part of macroeconomic policy and so of reorganising the economy to meet social and economic goals.

19. **Redistributing income and wealth within the economy.** Experience has shown that market economies are very good at concentrating income and wealth in the hands of a few people in a society whilst economics makes clear that this is harmful to the prosperity of society because it seriously reduces overall levels of demand in the economy. Redistribution of income and wealth is then an essential function that any Government must undertake and appropriately designed taxes are a proven and effective method for delivering this policy.

20. **Repricing goods and services.** Markets cannot always price the externalities of the goods and services they supply or reflect social priorities. Tax permits repricing of goods and services to reflect these facts.

21. **Raising representation in democracies**. There is little doubt that tax motivates interest in the democratic process. When people recognise that they pay tax they are more interested in engaging with the electoral process.

## Scottish tax principles

22. If the six reasons for tax are accepted then the principles that should guide the management of the Scottish tax system must be broader than those suggested by Adam Smith. They should instead recognise the fact that tax is the instrument that has the greatest power to shape many of the economic and social outcomes of the society in which we live. This suggests the following principles noted in the following paragraphs should form the basis for tax in Scotland:

23. ***The tax system should deliver the macro-economic goals of the Scottish government.***

24. ***The tax system should reflect the social priorities of the Scottish people.***

25. ***The tax system should encourage the engagement of all in Scotland in the democratic process.***

26. ***The Scottish tax system should be effective in:***

    a. ***Reducing economic and social stress within Scotland and between Scotland and other states;***
    b. ***Encouraging truthful, tax compliant behaviour;***
    c. ***Minimising opportunities for tax abuse.***

27. ***Additionally the Scottish tax system should be:***

    a. ***Integrated with other law, such as that regulating companies, partnerships and trusts to help deliver tax compliant behaviour and a level playing field for all Scottish businesses;***
    b. ***Be adequately resourced to achieve these objectives.***

## Practical difficulties in the implantation of these principles

28. In practice Scotland is a long way from being able to deliver on these principles at present for a number of very good reasons.

29. Scotland has not got its own currency and so does not have de facto control if its macro-economy.

30. Scotland does not have control over the money supply in Scotland, which largely determines the capacity to tax.

31. Scotland does not have control of QE in Scotland even though this is a significant factor in the tax equation.

32. Scotland does not have control of most of its taxes:

    a. On income tax it does not control of the most important aspect relating to inequality, which is the taxation of income derived from wealth;

    b. Scotland cannot create its own tax treaties;

    c. Most of the information required to undertake economic decision-making in Scotland is estimated and quite likely to be both inaccurate and inappropriate because it assumes Westminster retains control of the Scottish economy.

## The route to Scottish taxation

33. If Scotland is to have its own principles based tax system then a number of changes are required to the arrangements surrounding the management of Scottish taxation, as noted in the following paragraphs.

34. Scotland needs to be given greater control of its own macroeconomic policy.

35. Data to let Scotland manage its national income and to properly appraise its tax base needs to be collected.

36. Control of a much broader range of taxes must be devolved to Scotland. It must have control of a significant part of direct and indirect taxation, national insurance, corporation tax and taxes on capital if Scotland is to be said to have a tax system.

37. Scotland must be afforded the benefits of QE issuance that has de facto let the UK government come much closer to balancing its budget than has been admitted but from which it is not clear that Scotland has benefitted to date.

38. An agreed policy of Scottish deficit management within a UK national framework that takes into consideration the particular situation of Scotland and the choices that it can make needs to be established.

39. Revenue Scotland needs to be given a distinct and separate management function that lets it manage Scottish tax affairs in the Scottish interest at both policy and administrative level.

40. Scotland needs to run its own company, trust and beneficial ownership registries and have its own company law that creates its own reporting requirements and penalty regimes for non-compliance.

## Questions within this context

### A. Should Scotland establish its own income tax rates?

41. This question has to be answered at three levels:

    a. **Theoretically**: that is, to address the issue as to whether this might be desirable in principle;
    b. **Organisationally**: to back up the administration of tax by Revenue Scotland;
    c. **Practically**: that is, to address the issue as to whether this might be desirable at present.

42. **Theoretically**. The tax powers that have been devolved to Scotland by Westminster are largely symbolic and many have the appearance of being booby-trapped. The impression that Scotland is damned if it uses them and damned if it does not is hard to avoid. The fact that many of the tax charges required to impact on inequality, such as taxes on unearned income, capital gains, corporation tax and inheritance tax, are not devolved just adds to the impression that those powers devolved are intended to make sure that Scotland cannot deliver its own social policy through the use of its tax system. If, however, the Scottish government decides that it should build its taxation policies on the basis suggested in this paper, and that tax should be seen to have as strong a social as fiscal role in Scotland, then Scotland needs to indicate this fact by exploring the setting of new tax rates. The obvious move is to do this whilst seeking to be fiscally neutral for the time being. So, a very modest (maybe 1% ) cut in the basic rate matched by changes in higher rates should be used to indicate this direction of travel whilst the right to set broader tax policy should also be demanded.

43. **Organisationally**. Because Scotland cannot command its own economy unless it has control of its own taxes for Scotland to set its own basic rate of tax is to now require that Revenue Scotland tackle control of the task of identifying all Scottish resident taxpayers and resolve any potential disputes on dual residence. Given the importance of this task, which will not have priority until such time as a separate tax rate impacting most Scottish taxpayers is in existence, there is a strong organisational motive for setting a separate Scottish tax rate at this time.

**44. Practically.** There is also a practical motive for seeking to set such a rate now. HMRC is currently proposing to close almost all tax offices in Scotland: just two will be left, with one each in Glasgow and Edinburgh. This will mean that for many parts of the country a visit to a tax office will be nigh on economically implausible, incapacitating both the taxpayer and the ability of the tax authority to undertake frontline audits that are essential if tax abuse is to be curtailed. If the Scottish government wishes to prevent this disastrous outcome for taxation in Scotland it needs to step into the process now by demanding practical intervention to ensure there is a Revenue Scotland presence throughout the country. Setting a Scottish rate of tax will be a reason for requiring this.

## B. Should Scotland have its own laws on incorporation?

45. The question is a very real one:

    a. First, because some forms of Scottish incorporation – and the Scottish Limited Partnership in particular - are now being heavily abused internationally and their availability needs to be reviewed;

    b. Second, because a significant part of the tax gap arises because of the failure of the Registrar of Companies (based in Cardiff) and HMRC to have any effective control over their use;

    c. Third, because as a result if Scotland is to have control of its tax and economic policies companies operating in the country do need to be better controlled;

    d. Fourth, because the limited company in the form that we now have it is simply unsuited for use by most small business and it has instead become a vehicle for tax abuse for some, whilst sometimes being subject to inappropriate tax scrutiny for others who are trying to use it appropriately.

46. For these reasons Scotland needs to create its own laws on incorporation and its own Scottish Company Registry. This is the essential pre-requisite for bringing companies and associated entities operating in the country under Scottish control. The Register would also assume other duties, including that of being a company regulator tasked with ensuring that company law is complied with in Scotland.

47. The task of the Scottish Company Registry would not then be to act as a passive recipient of those documents companies might care to file as is the case of the current Cardiff based Registrar. The Scottish Company Registry would instead regulate all companies and similar entities registered in Scotland. Companies and similar entities would include the following:

    a. Limited liability entities of any sort;
    b. Partnerships, whether enjoying limited liability or not;
    c. Sole traders;
    d. Trusts;
    e. Charities;
    f. Foundations;
    g. Similar entities wherever incorporated, registered or managed in the world.

48. Any company or similar entity with a trade in Scotland would be required to register with the Scottish Company Registry even if not registered in Scotland. For these purposes trade would be defined as:

   a. an activity pursued for profit within Scotland;
   b. the ownership of land or the letting of tangible property in Scotland;
   c. the receipt of interest, rents, royalties, dividends or other sums due on intangible assets in Scotland;
   d. the management of a holding company or participation in a joint venture, partnership or other venture in or from Scotland; and
   e. pursuit of any such activity anywhere if more than 25% controlled, whether directly or indirectly, by a person or persons resident for tax purposes in Scotland.

49. The failure to register an entity undertaking a trade (as defined) in Scotland would render its contracts unenforceable in law and its property would be declared bona vacantia.

50. The Scottish Company Registry would as a result:

   a. Assume the task of registering all land in Scotland;
      - Land not registered within three years of the Register becoming active would pass to the control of a trust whose income would be dedicated to the provision of social housing in Scotland;

   b. Register all those in self-employment in Scotland providing details on:
      - The business owner;
      - The address at which they might be contacted;
      - The nature of the trade;
      - A business number without the use of which contracts could not be enforced by them;
      - Their VAT number, if registered;
      - The details of their business insurer, if such a policy is maintained;
      - But, importantly, no accounting information would be required.

   c. Register all partnerships trading with unlimited liability on the same basis as sole traders;

   d. Register all limited liability entities with a presence in Scotland requiring the disclosure of all information required of Scottish limited liability companies at present amended by the following additional disclosures;
      - Beneficial ownership of more than ten per cent of the entity;
      - The accounts submitted to the members of the entity without abbreviation;

- Country-by-country reporting including disclosure of the Scottish profits of the entity separate from those of all other jurisdictions or a statement that all profits arise in Scotland;
- The address from which the company trades in addition to the registered office: at least one of these two will, by definition, be in Scotland;
- Their VAT number, if registered;
- The details of their business insurance, if such a policy is maintained;
- Disclosure that the entity maintains a bank account if such information has been disclosed to the Registrar (see below);

e. Register all Scottish charities;
    - Details to be supplied to be discussed separately for the sake of brevity here;

f. Register all Scottish trusts, settlements and similar arrangements;
    - Details to be supplied to be discussed separately for the sake of brevity here;

g. Require that any insurer underwriting a policy for an entity required to be registered in Scotland register the details with it so that disclosure can be made on public record to protect those with potential claims;

h. Require that any bank providing services to an entity required to be registered in Scotland (including sole traders, partnerships, charities, limited liability entities of all sorts, trusts, foundations and similar entities) supply the following information to the Registrar for it to share with Revenue Scotland, albeit that such information exists will only be disclosed (but without any detail being supplied) for limited liability entities, charities, trusts and foundations:
    - The name of the bank supplying the service;
    - The entity to which the service is supplied;
    - The address at which the bank considers the services to be supplied;
    - The names, addresses and tax identification numbers of all those the bank considers to be managing the entity;
    - The names, addresses and tax identification numbers of all those the bank considers own more than 10 per cent of the entity;
    - The numbers of the accounts that the entity maintains with the bank;
    - The total sum deposited in the accounts of entity during a tax year excluding all transfers between the identified accounts.

i. Require that any person undertaking notifiable transactions in Scotland advise the Registrar if they cannot identify a party to the transaction on the Register. Identifiable transactions will include:
    - Any transaction in land including rental for more than four weeks;

- Any transaction in financial securities;
- Any transaction in the course of trade (as defined) for more than £1,000;
- Engaging with a person who represents that their activities are undertaken with charitable intent;
- Engaging with a person acting as a trustee or manager of a trust, foundation or similar entity.

51. If such a Registry was created then it would be possible to:

    a. Identify those undertaking economic activity in Scotland other than employment, significantly increasing the chance that tax might be collected;
    b. Enforce Scottish company law obligations;
    c. Identify Scottish corporate profits;
    d. Protect consumers by providing them with insurance data if they need to make claims against persons who have imposed a loss on them;
    e. Supply that information needed on limited liability entities that best protects those trading with them;
    f. Identify the ownership of Scottish land and so the income arising from it;
    g. Identify the ownership of Scottish wealth and so income arising from it;
    h. Ensure Scottish charities comply with their obligations.

52. Such a registry would then become the foundation on which a Scottish tax system might be based.