

FUNDING A SOCIAL RENEWAL

SCOTTISH BUDGET BRIEFING PAPER

**Philip Whyte and
Dave Hawkey**

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ABOUT THE AUTHORS

Philip Whyte is director of IPPR Scotland.

Dave Hawkey is senior research fellow at IPPR Scotland.

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EXECUTIVE SUMMARY

The Scottish government faces a challenging context for its budget.

With inflation at a forty year high, and recession now expected to last until the end of 2023, public funding squeezes are being felt across the UK. While the UK government's autumn statement saw spending not fall as drastically as expected over the next two years and brought some moves towards fairer taxation, sticking to spending review plans implies some departments will see their budgets fall significantly below the spending review's trajectory in real terms and deeper cuts have been scheduled for future years.

These decisions will undoubtedly exacerbate the challenges faced by departments still reeling from austerity – and the Scottish government is not immune from this.

While the announcements of the autumn statement mean the Scottish government is expected to receive £1.5 billion in additional Barnett consequential over the period 2023/24-2024/25, persistently high inflation will erode the block grant over the next two years, at which point further spending squeezes by the UK government will tighten public finances even more. This follows an emergency budget review from the Scottish government which saw £1.1 billion of spending cuts, savings and in-year reprioritisations, ostensibly to support improved public sector pay deals.

Beyond the economy wide impacts, the big story of the autumn statement was an economic outlook that makes grim reading for households across the UK – with disposable income in real terms falling 7 per cent over the next two years, taking the average household's incomes back to 2013 levels.

While the context is challenging, the Scottish government has made several significant, long-term commitments to tackle poverty and improve living standards – not least to develop a minimum income guarantee. That would be a significant move, but it will also not be immediate – unlike the struggles low-income households are facing – and it will also need to come with significant long-term investment in the social safety net.

The Scottish government therefore faces a serious question ahead of setting its budget: how to use its powers to it to boost household incomes now, while setting the groundwork for more fundamental tax reform to deliver on its long-term ambitions.

This briefing outlines the steps that could be taken to increase public revenue in the year ahead. It follows a report IPPR Scotland published in August, setting out measures to mitigate financial insecurity in the short-term and as first steps towards a longer-term ambition for a minimum income guarantee (Whyte and Parkes 2022) – we now show how those could be funded in 2023-24, including:

- Matching the UK government's decision to reduce the top tax rate threshold to £125,140 and freezing the remaining thresholds, raising £400 million.
- Protecting lower earning individuals by increasing the basic and intermediate rate thresholds by inflation would reduce this overall revenue by just £20 million.

- Every half percentage point increase on the higher and top rates of income tax – or two-percentage point increase on the top rate only – would raise an extra £100 million.
- A ‘progressive’ increase in council tax rates (i.e. higher increases for higher bands) while still protecting against rising inflation could bring in around £40 million.

While these steps would provide increased revenue for short-term improvements in the social security system, delivering the ambitions the Scottish government has set for itself will require more significant action. As such the Scottish government should commit to:

- **A root and branch review of the tax system ahead of the 2024-25 Scottish budget** to examine reforms to rates and bands, and how local tax raising powers could be used to address wealth inequality in Scotland.
- **Replacing council tax and non-domestic rates with a new, fairer system** that is either property or land value based. Our modelling shows how, even with ‘progressive’ increases across bands, the current system remains highly regressive.

The emergency budget review process exposed, to an extent, the limitations of the current devolution settlement, however that cannot become an annual excuse for in year cuts. The tax provisions of the Smith Commission which gave rise to the Scotland Act 2016 were endorsed by all parties represented in the Scottish Parliament, and so now should their use to tackle the big issues Scotland is facing. That requires thinking bigger and using all available powers in a more progressive way to secure sustainable revenue to fund Scotland’s collective priorities.

PROGRESSIVE INCOME TAX

It is generally well understood that spending cuts or increases by the UK government feed into Scotland's block grant, which is still used as the starting point in setting how much the Scottish parliament has to spend. However, what is often overlooked is that tax increases or cuts in the rest of the UK also have a significant effect on Scotland's budget.

If a tax devolved to Scotland goes down in the rest of the UK, Scotland will see a lower income tax block grant adjustment (and in turn more funding), but if a devolved tax goes up the Scottish government would need to follow suit to ensure spending plans in Scotland do not fall behind those seen in the rest of the UK.

As such, the UK government's decision to increase income tax will mean that the Scottish government will need to at least match these changes just to stand still. While reprioritising spending must be part of the solution, it is unlikely this will be enough on its own.

Scotland already has a more progressive approach to income tax than the UK government, which we estimate raises around £920 million more in Scotland than if rest-of-UK rates prevailed.¹ Further income tax increases are the most effective option for supporting public spending, with those with the broadest shoulders contributing most.

Progressive tax rises would increase the revenue available for measures to tackle the cost-of-living crisis and contribute to the Scottish government's commitment to reduce child poverty – and opinion polling shows that is supported by the wider public.

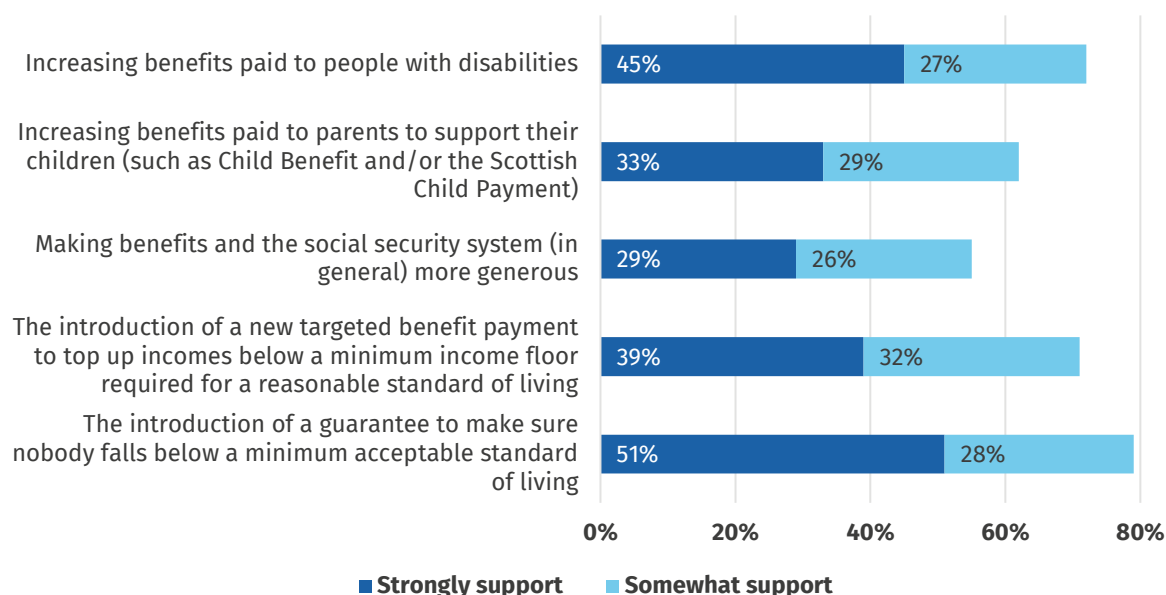
The figure below shows public support for a range of policy proposals – even if it meant a consequent tax increase – from polling conducted on behalf of IPPR Scotland earlier this year (but, notably, still within the period of the current cost crisis).²

¹ Source: authors' analysis using IPPR tax-benefit model. Comparison of UK post-Autumn statement 2023/24 income tax rates and thresholds with our baseline scenario which assumes the top rate threshold is reduced to £125,140, the higher rate threshold is frozen at £43,662, the remaining thresholds increase by inflation, and tax rates in each band remain at their 2022/23 levels.

² The survey was designed by Diffley Partnership and invitations were issued online using the ScotPulse panel. Results are based on a survey of 1094 respondents. Fieldwork was conducted between 16th – 20th June 2022. Results are weighted to the Scottish population by age and gender estimates from 2020. This question asked: *To what extent would you say you would support or oppose the following initiatives if it meant your own taxes became slightly higher?*

FIGURE 1: THE PUBLIC SUPPORT A VARIETY OF POLICY PROPOSALS TO HELP THOSE ON LOW INCOMES

Proportion of respondents supporting proposals when asked “To what extent would you support or oppose the following initiatives if it meant your own taxes became slightly higher”



Source: Poll of 1,090 adults conducted by Diffley Partnership on behalf of IPPR Scotland, June 2022

This shows there is strong public support for tax increases where the increased revenue is used to fund the social safety net. The Scottish government should now follow that public opinion through to its draft budget.

To demonstrate the options available to the Scottish government, we have modelled changes to Scottish income tax thresholds and rates, designed to bring in higher revenue from the upper end of the income scale while seeking to ensure tax increases do not burden households at the lower end of the income spectrum.

Option 1: Expand the revenue collected by the higher and top rates by freezing the threshold for the former and lowering the threshold of the latter.

The UK government has reduced the threshold at which households outside Scotland pay the additional rate (45 per cent) from £150,000, to £125,140, and frozen the threshold for the higher rate. Mirroring this action in Scotland by **lowering the top rate threshold to the UK level and freezing the higher rate threshold would raise around £380 million in 2023-24**, compared with increasing the higher rate threshold by inflation and retaining the £150,000 top rate threshold.

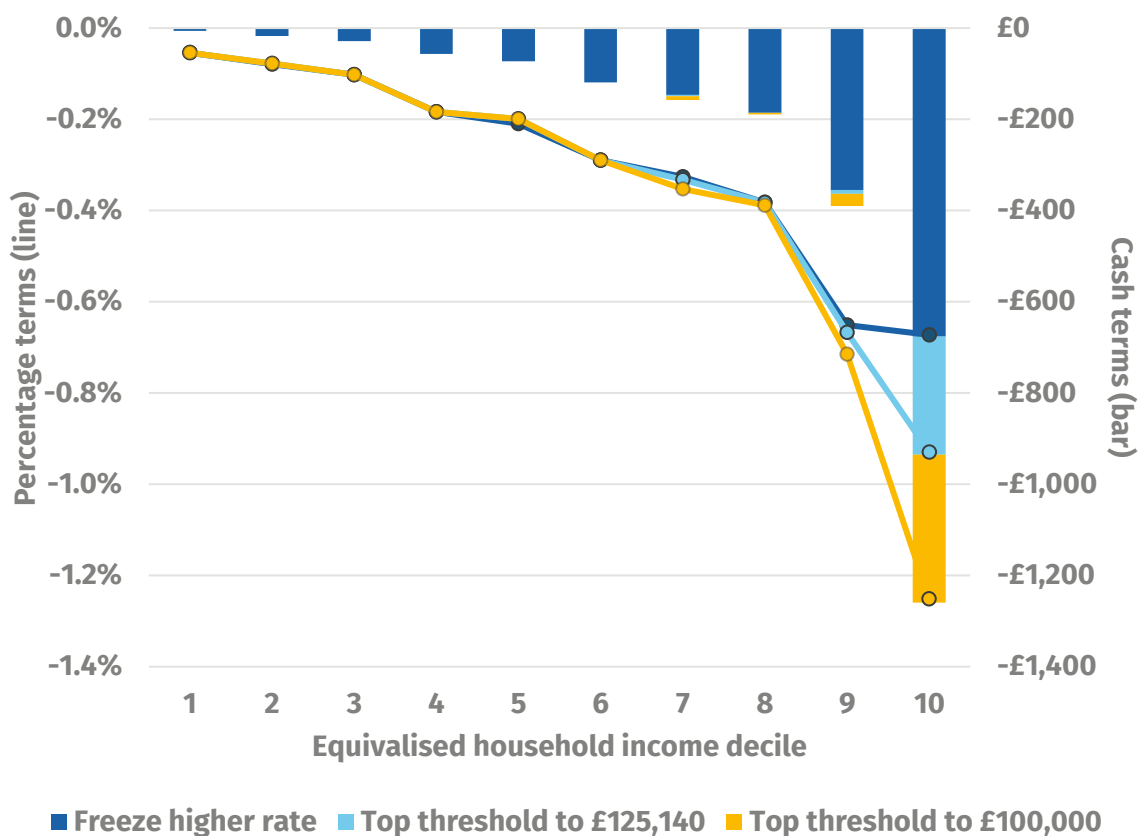
The threshold for the Scottish top rate of tax is not tied to the UK threshold, however, and the Scottish government could go further.

Above an income of £100,000, an individual’s personal allowance begins to taper, reducing by £1 for every £2 additional income. The UK government’s top rate threshold of £125,140 is the income level at which the personal allowance has tapered to zero. However, as the tapering process is a recognition that £100,000 is an unusually large income, the top rate could be aligned to the point at which the personal allowance begins to taper, rather than the point at which it ends. **Lowering the top rate threshold to £100,000 would raise a further £70 million in 2023-24.**

Lowering the threshold for the top rate of tax in these ways is highly progressive and predominantly impacts households in the highest income decile. Households in the fifth and lower deciles see a tax increase, on average, equivalent to less than 0.2 per cent of disposable income.

FIGURE 2: FREEZING THE HIGHER RATE AND LOWERING THE TOP RATE WOULD BE PROGRESSIVE

Average impact on disposable income of threshold policies by equivalised household income decile (AHC)



Source: Authors’ analysis using IPPR tax-benefit model. Calculated against a counterfactual in which the higher rate threshold increases with inflation and the top rate threshold remains at £150,000. Income deciles here and throughout this report are determined by our central scenario of a frozen higher rate threshold and a top rate threshold of £125,140.

Option 2: Raise the higher and top income tax rates to increase revenue coming into the Scottish budget

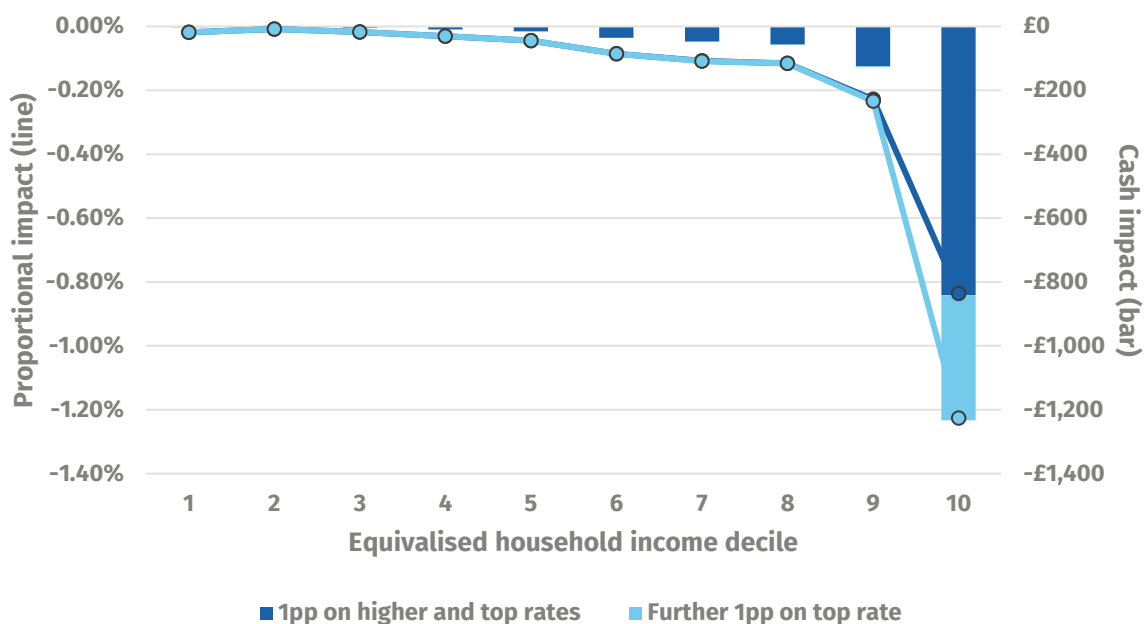
We calculate that around 560,000 taxpayers' incomes will be above the frozen higher rate threshold, and around 40,000 of these above the £125,140 top rate threshold, concentrated in the upper deciles of the income spectrum. While all households experience the impacts of inflation, the wealthiest have the largest income buffers. In the current context it is therefore reasonable that these households should be asked to contribute more to the public finances. Next, we examine how revenue would change with altering these rates.

We estimate that, **every additional £100 million the Scottish government wished to raise for the Scottish budget could be delivered by increasing the higher and top rates by a half percentage point.** Were the increase only to apply to the top rate, every additional £100 million needed could be delivered by a two-percentage point increase.

To illustrate the distributional impact, we modelled adding one percentage point on the higher and top rates (raising £200 million), plus an additional one percentage point on the top rate (raising a further £50 million). The impact is highly concentrated at the top of the income distribution. The average impact on households' disposable income in the fifth- and lower-income deciles would be less than 0.05 per cent.

FIGURE 3: INCREASING THE HIGHER AND TOP RATES OF TAX PRIMARILY AFFECTS HOUSEHOLDS IN THE TOP 10 PER CENT

Average impact on disposable income of illustrative increases to income tax rates: higher and top rates increase by one percentage point, and top rate by a further one percentage point



Source: Authors' analysis using IPPR tax-benefit model

If adopted, these measures can provide some immediate fiscal space for the Scottish government to take targeted action to directly boost incomes for those most impacted by the cost-of-living crisis, and the first step towards its longer-term ambitions. However, to fully deliver on long-term ambitions, more fundamental reform is needed – and the current economic situation means now is the time to look deliver that.

The Scottish government should commit to fundamental reform of the tax system, within this parliament, starting with a national consultation ahead of the 2014-25 draft budget being published. This should include reforms to the existing system of rates and thresholds, but also options to use wider powers to instigate new forms of taxation.

While devolved tax represents a significant lever, under current policy its revenue (excluding council tax and non-domestic rates) still only accounts for around a third of total Scottish government resource funding. The total revenue generated, and the offsetting impacts of the block grant adjustment, are driven by a range of factors including the relative growth in earnings in Scotland compared to the rest of the UK and the profile of Scottish taxpayers.

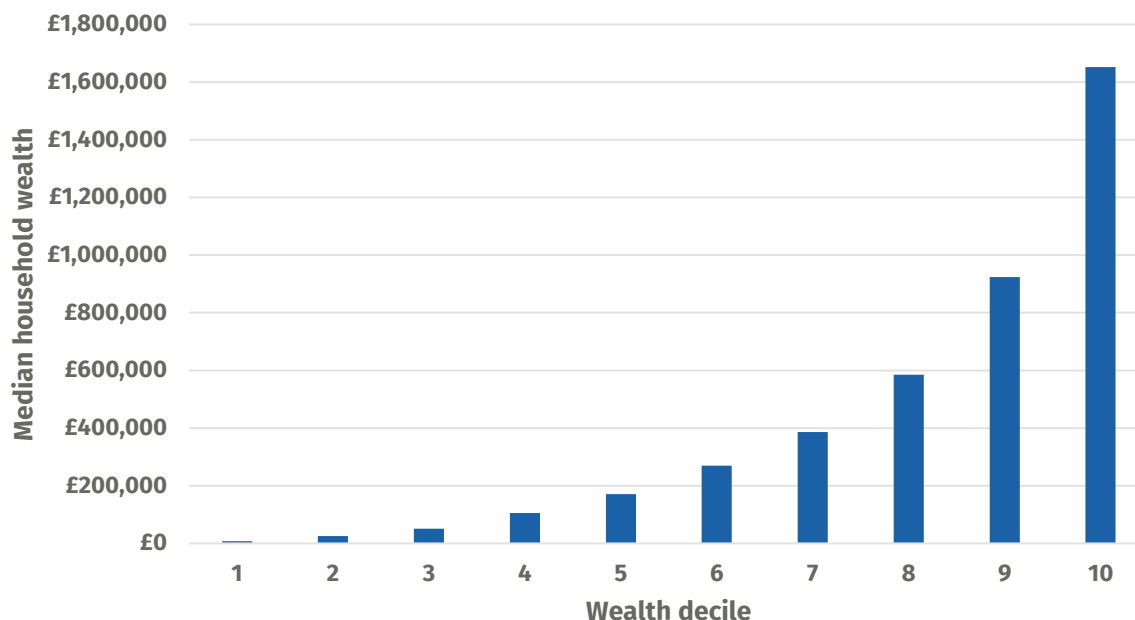
The distribution of Scottish income taxpayers is heavily skewed towards the lower end of the income distribution: over half of taxpayers sit in the starter and basic rate compared to less than 1 per cent in the additional/top rate (UK government 2022). That demonstrates a need to reconsider how thresholds are designed and what rates are applied, but also hits up against some of the limitations within current powers, not least that the personal allowance remains reserved and income tax powers relate to non-savings, non-dividend income only – both areas where further devolution may be merited.³

Conversely however, statistics show that Scotland has the third highest most unequal distribution of wealth of any UK nation or region. As the chart below shows, median household wealth is significantly skewed towards the top decile who hold an average of £1.7 million in wealth compared to £7,600 held by the bottom decile (Scottish government 2022a).

³ While the personal allowance is reserved, if the Scottish government wished to effectively raise it, it could do so by introducing a 0% rate on a certain level of income above the UK allowance (replacing the current starter rate of 19%). This should be a consideration of any future tax reform.

FIGURE 4: WEALTH DISTRIBUTION IN SCOTLAND IS HIGHLY UNEQUAL

Median household wealth (physical, property, financial and pension) by wealth decile in Scotland 2018-2020



Source: IPPR analysis of Scottish government (2022a)

Alternative revenue raising options must be explored to deliver on the big policy priorities for Scotland.

The Scotland Act 1998 devolved wide powers around local taxation to fund local authority expenditure. In the absence of other limiting statute, this means that the Scottish parliament could, in theory, introduce a broad range of new forms of taxation, if the revenue is used to fund local authority spending. In turn this could free up resource currently used for local government grants for other means. Importantly, this could start to address the vast disparities in wealth we see in Scotland and open further opportunities to raise the necessary revenue to fully deliver on the government's stated priorities. IPPR Scotland will be undertaking further work on this in the months ahead as part of our longer-term vision for a reformed social contract.

REFORMING COUNCIL TAX

Council tax represents a significant source of revenue for local authorities, with £2.7 billion billed in 2021/22 after council tax reduction (Scottish government, 2022b). However, it is also well recognised as being generated in a regressive way. Bills are lowest as a proportion of home value for those in the highest value properties *and* as a proportion of income for the highest income households, albeit council tax reduction corrects for this to an extent for the very lowest income households (Gunson et al 2021).

The previous council tax freeze not only perpetuated this regressive revenue generation but did so in a way which then generated between £600m and £900m a year less than would have been the case if it was set at the same level as in England and Wales (Fraser of Allander Institute, 2019). Essentially, the policy decisions taken have reduced revenue while not necessarily making the system fairer.

Despite the inherent shortcomings within the current system, its potential as a revenue raising tool in the short-term cannot be overlooked. The key is to ensure whatever limited progressive elements within the system exist are utilised to make it as fair as possible.

We examined the effect of increasing council tax for the higher bands. In our scenario:

- **Bands E, F, G and H see an increase in council tax rates of six, nine, twelve and fifteen per cent respectively, against a baseline of three per cent.**
- **Bands A to D see a three per cent increase in our baseline and comparison scenarios.**

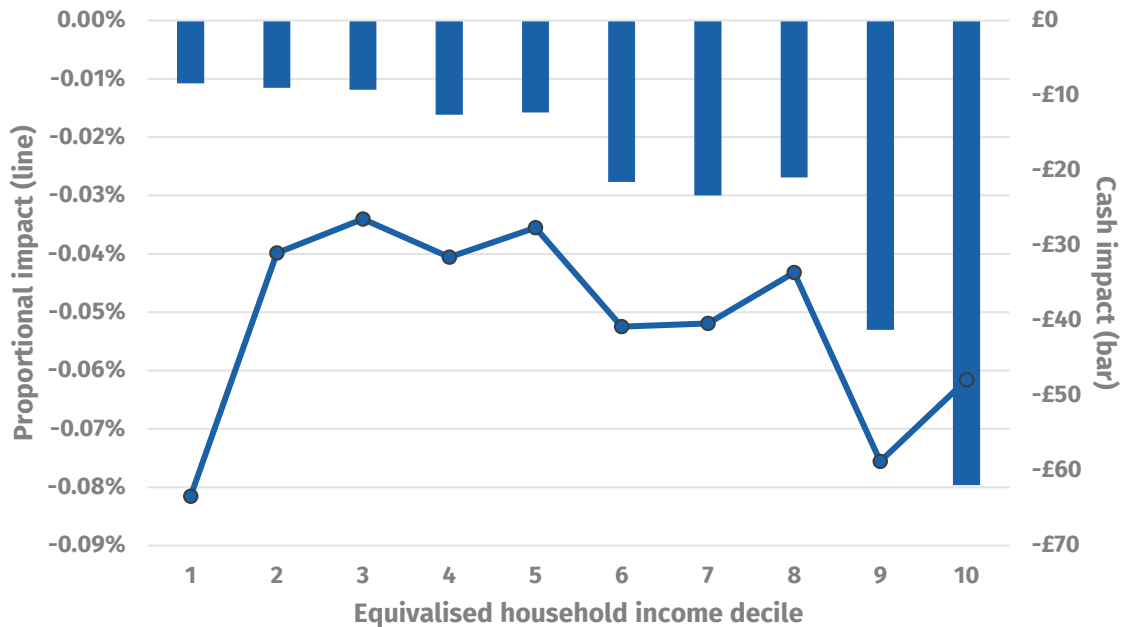
This would mean lower-value bands would be protected from inflationary increases which would only kick in (based on current inflation) for higher value properties, and the very highest value bands would see an above inflationary increase.

This would increase modelled council tax revenues by around £60 million (or two percent above the baseline), though about a third of this would be counteracted by council tax reduction, leaving a net increase of around £40 million.

The fact that applying what appear to be progressive increases still increases council tax reduction illustrates the disconnect between tax bands and household incomes. In consequence the distributional impact of this policy would have regressive elements, including the lowest income decile seeing the highest proportional impact on their disposable income.

FIGURE 5: INCREASING COUNCIL TAX FOR THE HIGHER BANDS ONLY DOES NOT TRANSLATE INTO A PROGRESSIVE TAX INCREASE

Average impact on disposable income of increasing council tax in bands E to H by progressively higher proportions.



Source: Authors' analysis using IPPR tax-benefit model

It is unsurprising that household incomes bear little relation to council tax bands set by reference to valuations in 1991. Even with larger increases to the higher bands than lower bands, council tax is unable to collect income in a progressive manner. Ultimately, the current system is not suitable to deliver long-term funding for local services in a way that is progressive.

Despite manifesto commitments and commissions, we are yet to see any fundamental reform of council tax in Scotland. But, if we are to maximise the potential for local taxes to play their part in funding national priorities and take greater action to protect those on the lowest incomes, now is the time to do so. **The Scottish government should commit to working on a cross-party basis to replace the current system before the end of this parliament.**

Our view is reform should take the form of a new percentage of value tax, introduced incrementally (given the timescales full roll-out may require) but with the process starting quickly. Previous IPPR Scotland research has estimated one such property tax which could raise around an additional £350m per year compared to the current system.

This should also include bringing businesses within local land and/property value taxes – replacing the existing non-domestic rates system. The current system, including exemptions, representing a significant source of forgone income while not necessarily delivering better business outcomes (Fraser of Allander, 2022) – with a system that is fairer for local communities and can contribute to increased public revenue.

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