IPPR SCOTLAND

REPORT

NEW POWERS, NEW SCOTLAND?

HOW THE SCOTTISH PARLIAMENT COULD USE ITS NEW TAX AND BENEFIT RESPONSIBILITIES

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Institute for Public Policy Research

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SUMMARY

Scotland is increasingly taking on more powers and responsibilities over devolved income tax and benefits. Following the successful passage of the Scotland bill, it is estimated that these powers will mean that Scotland will have control over revenue totalling almost half of devolved expenditure by the Scottish government and Scottish local authorities, and 15 per cent of Scottish benefit spending.

This development prompts two core questions. First, what will be the likely impact of the Scottish government using its new powers to offset short-term challenges that are expected to reduce Scottish household incomes and lead to a deterioration in the Scottish fiscal position? And second, over the medium and long term what is the likelihood of the Scottish government developing its own distinctive tax and benefit system?

On tax, the Scottish government's new powers over income tax offer significant flexibility to reduce or increase tax paid on earnings by Scottish households, particularly those further up the distribution.

On benefits, while coverage of devolved disability benefits is low, changes to the level of these benefits can have a significant impact on a claimant's living standards.

Effect of tax-benefit changes in Scotland

Scotland faces a series of short and medium-term challenges.

- Welfare cuts planned at a UK level will see benefit spending in Scotland fall by £600 million a year by 2020/21.
- These cuts will vastly outweigh the benefit from the new national living wage for the poorest households in Scotland. Among the 700,000 Scottish households who will be negatively affected by the changes, losses will average £730 per year.
- Planned UK government income tax cuts will reduce tax revenues in Scotland by £600 million a year by 2020/21 if matched in Scotland, comprising £300 million lost due to an increase in the personal allowance, over which the Scottish government will have no control, and a further £300 million lost if Scotland matches UK government increases in the higher rate threshold. If operating as intended, the fiscal framework should insulate the Scottish budget from reductions in tax revenue from reserved decisions (such as increased personal allowance).
- If implemented in full in Scotland, these tax cuts would benefit Scottish households, but the biggest winners will be those at the top of the earnings distribution, who will on average gain £590 a year.
- Devolved spending will be reduced further over the coming years as a result of UK-wide spending decisions. The Scottish block grant, under current arrangements, is expected to see reductions in total departmental spending of 4.2 per cent, or £1.2 billion, in real terms between 2015/16 and 2019/20.
- The projected reduction in Scotland's working-age population could see a £300 million decrease in Scottish tax revenues when compared to projected working-age population growth across the UK as a whole. The fiscal framework, agreed through to 2022, should insulate the Scottish budget from changes in population, if it operates as intended.

Options for the Scottish parliament

Given these pressures on Scotland's public finances and households, how could the Scottish parliament's new powers (and some existing powers) over taxes and benefits be used: 1) to reduce or eliminate the impact of cuts to the Scottish parliament's block grant; 2) to mitigate or reverse cuts to benefits in Scotland; and 3) to reshape Scotland's tax system.

The fiscal effects of using the Scottish parliament's powers are as follows.

- Varying the basic rate alone (a 1p change) would see revenue grow/fall by £400 million by 2020/21. Varying the higher rate alone would see revenue grow/fall by £100 million (an increase of 1p in the higher rate) per year in 2020/21. Varying the basic, higher and additional rates of tax by 1p in the pound would see revenue grow/fall by £500 million annually by 2020/21.
- Freezing the higher rate threshold in cash terms would raise revenue by £300 million per year by 2020/21. Increasing the higher rate threshold by CPI inflation would raise £100 million by 2020/21, relative to a business-as-usual case of inflation-indexation of the basic rate limit.
- Increasing taxes on the highest earners by reducing the additional rate threshold in Scotland from £150,000 per year, would raise around £8.5 million per year for a £10,000 reduction.
- Increasing the current rates of council tax could increase revenues to Scottish local government by £100 million (if increased in line with inflation – a real-terms freeze) or £200 million (if increased in line with average earnings) per year in 2020/21, relative to continuing the Scotland council tax cash-terms freeze.
- Reversing the planned UK government cuts to universal credit work allowances would cost the Scottish government £200 million by 2020/21, increasing the incomes of 200,000 claimant households by an average of £990 a year.
- Reversing the planned UK government freeze to working-age benefits would cost the Scottish government £200 million by 2020/21, increasing the incomes of 900,000 claimant families by an average of £230 a year.
- Increasing disability benefits in line with earnings would increase the disposable income of households claiming these benefits by an average of £490 per year at a cost of £100 million per year by 2020/21.

Key challenges

After the parliamentary elections in May, the next Scottish parliament will face six key challenges:

- **Challenge 1:** What, if anything, should the Scottish parliament do to reverse UK-wide benefit cuts in Scotland?
- **Challenge 2:** Given UK government plans to increase the higher rate income tax threshold to £50,000, at what level should the higher- and additional-rate thresholds be set for higher earning Scottish taxpayers?
- **Challenge 3:** What should the Scottish parliament do to boost earnings in Scotland, at least in line with UK-wide earnings increases?
- **Challenge 4:** What should the Scottish parliament do to grow the working-age population in Scotland, at least in line with growth in the rest of the UK?
- **Challenge 5:** What, if anything, should the Scottish parliament do to reverse public spending cuts affecting Scotland over the coming years?
- **Challenge 6:** How, if at all, should the Scottish parliament radically reform the income tax system in Scotland over the coming years?

1.
INTRODUCTION

The implementation of the Scotland bill's provisions for the devolution of taxes and benefits to Scotland will see Scotland gain control over an unprecedented 50 per cent of its income and 15 per cent of its benefit spending (Phillips 2014). While the proposals currently being debated do not amount to a fully devolved system of tax and benefits, they will give the Scottish parliament much more flexibility than currently possessed to reshape the tax-benefit system. As a result, there will be the potential for far-reaching consequences for the fiscal position of Scotland, the shape and size of the state, and for the living standards of Scottish households.

Devolution of tax powers to Scotland began in 1999, when the new Scottish parliament was granted the (never used) power to vary the main rate of income tax by up to 3 pence in the pound, in addition to the already held power of Scottish local authorities to raise council tax and business rate revenue.

Building on the Calman commission, which published its final report in 2009, the 2012 Scotland Act strengthened tax-raising powers through the devolution of stamp duty and the landfill tax from April 2015 and the creation of the Scottish rate of income tax (SRIT) from April 2016. The SRIT sees all UK income tax bands reduced by 10 pence in Scotland, with the Scottish parliament given the powers to add a Scottish rate, in lock-step, across the bands, and to retain the revenue from this Scottish rate.

Calls for more powers for the Scottish parliament grew with the election of a majority SNP Scottish government in 2011 and the subsequent independence referendum campaign in 2014. Following the 'no' vote, the five parties represented in the Scottish parliament took part in the Smith commission, which published its report in November 2014 setting out proposals for further devolution. Its recommendations included several relating to tax and benefits, including full control over income tax in relation to earnings above the personal allowance, and a number of powers in relation to benefits. Its recommendations led to the Scotland bill, currently passing through the UK parliament.

Running alongside this debate on new powers for Scotland, at a UK-wide level there are fundamental changes taking place that will reshape the tax and benefit system throughout the rest of this decade and beyond. These changes include sweeping cuts to working-age welfare including tax credits and the new universal credit, and cuts to disability benefits and employability programmes due to be devolved. At the same time, other parts of the UK government's policy programme, such as the introduction of a new national living wage, will have a sizable knock-on impact in Scotland.

With the rapid pace of devolution over taxes and benefits to Scotland, it is important to explore the implications for Scotland both of using the Scottish parliament's current and planned powers, and of changes to the UK-wide tax and benefit system to see what system Scotland will inherit. In order to inform the public debate in Scotland, this paper looks in detail at these questions. It starts by setting out the powers that the Scottish parliament has, and is due to receive, over taxes and benefits. We then turn to the impact on Scottish households and on the fiscal position of Scotland were the next Scottish government to choose to use its new powers, before illustrating the opportunities and threats presented by Scotland's new powers in the context of UK-wide announced and planned changes to reserved taxes and benefits. This report does not outline how we believe the powers *should* be used – that is for later work – but instead we focus on how powers *could* be used.

Although this paper does consider the proposed devolution of taxes on businesses, such as the aggregates levy, it does not *model* these, as the IPPR Scotland tax-benefit model focuses on taxes and benefits as they interact with households. In addition, we do not discuss in detail the important question of the administration of devolved taxes and benefits (which may prove complex and costly). Both of these considerations will be of huge importance in the coming months and years, and IPPR Scotland will look to explore them in more detail in its future work.

IPPR Scotland's tax-benefit model

In order to inform the public debate on Scotland's existing and new powers over tax and benefits, IPPR Scotland has built a micro-simulation model of the tax-benefit system for Scottish households. The model makes use of household-level data from the UK Family Resources Survey for 2011/12 to 2012/13. This provides a sample size of 6,000 Scottish households with which to assess the fiscal and distributional impact of changes to the tax-benefit system in Scotland.

IPPR Scotland's tax-benefit model is a microsimulation model of key elements of the UK tax and benefit system, based on data contained within the Family Resources Survey (FRS). The model contains information on income, benefit receipt, the demographic composition of households and families, together with information about the parameters of the UK tax and benefit system.

The model allows us to analyse changes to the structure of the tax and benefit system. This includes changes to all aspects of income tax and changes to the value of benefits and who is eligible to receive them. It calculates the distributional impact of these changes along a variety of dimensions, including household and family type (for example pensioners vs adults with and without children) and family and household income. In addition, it can assess the overall and disaggregated fiscal impact of policies, as well as their impact on various measures of inequality and poverty.

Since the model covers the whole of the personal tax, benefit and tax credit systems, it enables us to model a combination of changes and understand the overall effects, taking into account interactions between different taxes and benefits. We are also able to model a number of different changes simultaneously, enabling comparisons between different reforms or sets of reforms.

The model can also vary underlying economic factors such as the employment rate, earnings growth and housing costs; and analyse the distributional and fiscal impacts of the change. And it can be used to project into the future based on economic forecasts of these factors, in order to analyse the tax-benefit system at a future date.

The model does not calculate the behavioural impact of changes to tax and benefit rates. This means that all tax-benefit changes analysed in this paper assume that household earnings, hours of work, employment status and other factors are unchanged as a result of a change in tax or benefit rates and rules, even though in practice these may change the incentives for individuals to work more or less. In addition, we assume 100 per cent take-up for all means-tested benefits (such as universal credit).

2.
TAX AND BENEFIT POWERS IN SCOTLAND

This chapter sets out the tax and benefit powers the Scottish government already has or will have following full implementation of the Scotland bill. It explains what the powers being devolved will do, any known potential restrictions on the Scottish government's usage of these powers, and how much tax revenue–benefit expenditure each power represents as a proportion of total tax revenue–benefit expenditure in Scotland. It also discusses the general principles underlying the Scotland bill, and their implications for Scotland following devolution of powers. These changes will also comprise a significant shift in the way the Scottish parliament receives its revenue, away from block grants received from the UK government and towards revenue collected and retained within Scotland in the form of direct and indirect taxes.

2.1 Current powers

2.1.1 Council tax

Since its introduction in 1993, local authorities in Scotland have had control over setting council tax rates for residential properties in each of the eight valuation bands (A to H), with the Scottish parliament gaining responsibility for Scotland's local government framework from 1999. Council tax forms around 17 per cent of Scottish local authority expenditure (CIPFA 2015), and in 2015 raised £2.1 billion (Scottish Government 2015a). While local authorities have control over setting council tax rates, the Scottish government has worked with local areas to freeze council tax rates since 2007 – which has seen the share of local authority expenditure funded directly by grants from the Scottish government rise from 78 to 83 per cent (CIPFA 2015). Equally, the ratios between the bands are fixed and set by the Scottish parliament. Local authorities also administer the national means-tested council tax reduction scheme (which is localised in England).

2.1.2 Business rates

Business rates, or 'non-domestic rates', are a property-based tax charged to businesses as well as the public and third sectors based on a property's value. In 2013/14 the Scottish government raised £2.4 billion from business rates. Local authorities collect business rates, which are pooled centrally. The Scottish government and local authorities themselves also operate a variety of schemes to incentivise growth in business rates (through local authorities retaining 50 per cent of any revenue generated above their target), and to offer relief to particular property users, including small businesses and charities (Berthier 2015) and supplements for larger businesses. In 2015 Scotland introduced new flexibilities affording local government in Scotland the ability to cut business rates in their area (Scottish Government 2015b) and initiate a forthcoming review of the business rates system in Scotland.

2.1.3 Scottish variable rate of income tax

The Scotland Act (1998) gave the Scottish parliament the power to vary the standard rate of income tax, payable on income earned between the tax-free personal allowance and the higher rate threshold, by up to 3p in the pound. The Scottish government has never used this power (Scottish Government 2015c).

2.1.4 Stamp duty land tax

From April 2015, the Scottish parliament received full control over stamp duty land tax. The Scottish government replaced stamp duty land tax with a new land and buildings transaction tax (LBTT). Both the Scottish system and the system in the rest of the UK now operate similarly, following changes in the rest of the UK in 2014, with a tax-free amount for any property transaction, before rates applying over subsequent bands. The Scottish tax does, however, operate over different bands than the tax in the rest of the UK; for example, the 12 per cent highest rate on residential properties begins at £750,000 in Scotland, but at £1.5 million in the rest of the UK. In 2015/16 the LBTT is on course to raise around £200 million per year for the Scottish government (Revenue Scotland 2015a).

2.1.5 Landfill tax

Also from April 2015, the Scottish parliament received full control over taxes on landfill disposals. The Scottish government has set the standard and lower rates at the same level as the rest of the UK (although eligibility for each rate may differ). Based on the first estimates from Revenue Scotland (covering April–June 2015), the Scottish government can expect to raise a little over £100 million a year from the new landfill tax (Revenue Scotland 2015b).

2.2 Powers from 2016

2.2.1 Scottish rate of income tax

The Scottish parliament will have further powers in relation to income tax from April 2016. The new powers will see all the basic, higher and additional rates of income tax on non-savings, non-dividend income (currently 20, 40 and 45 per cent respectively) reduced by 10p in Scotland. The Scottish parliament can then decide how much tax, if any, to put back on to each of the bands. The remaining 10p, 30p and 35p in the pound will continue to be retained by HMRC at a UK level with the new Scottish rate of income tax (SRIT) revenue retained by the Scottish government. For 2016/17, the Scottish government has decided to reinstate the 10p cut, meaning there will be no difference in income tax rates across the UK. It is estimated that the Scottish government will raise £4.7 billion from the SRIT (Berthier 2014). The Scottish parliament will have no powers over the bands within which the SRIT operates, meaning that changes to bands announced by the UK government, such as their plans to increase the personal allowance and higher rate threshold, will have an impact on Scottish government revenues. In addition, a change in rate to one band must be applied to all, under the ‘lock-step’ principle which has also been proposed in Wales.

2.3 New Scotland bill powers

2.3.1 Rates and thresholds of income tax

The Scotland bill will see the Scottish parliament given full control over the rates and bands of income tax on non-dividend, non-savings income, and will receive the full income tax revenue collected in Scotland. The tax-free personal allowance (the point at which earnings begin to be taxed) will remain reserved to the Westminster parliament and income tax will continue to be collected by HMRC. The UK government also retains control and the ability to set any tax reliefs. This means that the UK government can affect Scottish tax revenues through increases in the personal tax allowance and potentially changes in tax reliefs; however, the agreed fiscal framework should insulate Scottish parliament revenues from changes to reserved tax policy, if it operates as intended. The current expectation is that the Scottish parliament will gain these powers in April 2017 (BBC 2015a).

2.3.2 VAT

The Scotland bill will see Scotland keep the first 10 percentage points of the standard rate of value added tax and the first 2.5 per cent of the reduced VAT rate. While this will boost Scottish revenue, other aspects of VAT, such as which goods are charged and at which rate (exemptions, the reduced rate of 5 per cent or the standard rate of 20 per cent) will remain reserved to the UK government. Therefore this is simply a transfer of revenue (typically called an assigned revenue) and not of powers.

2.3.3 Air passenger duty

The Scotland bill will see full devolution over air passenger duty (APD), a levy charged on passengers leaving Scottish airports. The Scottish government has subsequently set out plans to halve the level of APD when devolution occurs (April 2018), with a longer-term ambition to eliminate APD entirely (Scottish Government 2015d). In 2012/13 air passenger duty raised approximately £200 million in Scotland (Phillips 2014).

2.3.4 Aggregates levy

The Scotland bill proposes that the aggregates levy be fully devolved to the Scottish parliament. The Scottish government have not, as yet, indicated how they would change the current structure of the aggregates levy, a tax on sand, gravel and rock that is either imported or extracted from the ground or sea. The tax is intended to reflect environmental costs associated with the extraction and use of these materials. The amount raised by the tax in Scotland in 2012/13 was less than £100 million (Phillips 2014)

2.3.5 Attendance allowance

Attendance allowance – a benefit paid to over-65s who are assessed as having a physical or mental disability that requires personal care – will be devolved through the Scotland bill. It is important to note that other benefits can be affected by claiming attendance allowance. It is non-contributory, non-means-tested and tax-free. The cost of attendance allowance in Scotland in 2013/14 was £481 million (Kennedy 2015).

2.3.6 Disability living allowance

Disability living allowance (DLA) is a benefit paid to those who require help with living costs due to requiring personal care or help with mobility, with different rates for each and the level of support needed. In 2013/14 the DLA bill in Scotland was £1.5 billion (ibid).

2.3.7 Personal independence payments

Personal independence payment (PIP) is a new benefit that will replace DLA gradually over time. It is expected that substantially fewer individuals will ultimately be eligible for PIP than were eligible for DLA (600,000 across the UK). DLA was retained for those aged under 18 and those over 65 when PIP was introduced. New claims will move straight onto PIP, and over time all DLA claimants of working age will be reassessed in the rest of the UK. Only £20 million was spent on PIP in Scotland during 2013/14, although this will increase as it is rolled out (ibid). Citizens Advice Scotland has argued that, since the Scottish government would like to develop an alternative system for PIP, rollout of the UK-wide benefit should be halted in Scotland until full devolution has taken place, in order to prevent individuals having their claim reassessed several times (BBC 2015b).

2.3.8 Carer's allowance

The Scotland bill will devolve carer's allowance, which is a benefit for individuals unable to work because they care full-time for a disabled person who claims particular components of PIP, DLA or attendance allowance. Spending in Scotland on carer's allowance in 2013/14 was £182 million (Kennedy 2015). The current Scottish government has indicated that it would like to increase the rate of carer's allowance to the same rate as jobseeker's allowance, from £62.10 a week to £73.10 (BBC 2015c).

2.3.9 Industrial injuries disablement benefit (IIDB)

The IIDB is a benefit for those disabled as a result of an industrial accident or a prescribed industrial disease, with the amount offered increasing in line with the degree of disability. Currently, £90 million is spent in Scotland on IIDB, which will be devolved through the Scotland bill (Kennedy 2015).

2.3.10 Severe disablement allowance

Severe disablement allowance (SDA) is a benefit for those unfit to work, but has been closed to new claims since 2001. It is expected that eventually the vast majority of claimants will transition to employment support allowance in the rest of the UK, which is not proposed for devolution. Currently, £90 million is spent a year (2013/14) on SDA in Scotland (ibid).

2.3.11 Winter fuel payment – regulated social fund

The regulated social fund – which comprises winter fuel allowance, cold weather payments, funeral expenses payments and sure start maternity grants – is scheduled for devolution. These payments are, respectively, tax-free allowances for winter fuel bills, for recipients of other benefits to deal with severely cold weather, to deal with funeral costs, and to deal with costs associated with maternity for the first child in a family. The vast majority of the regulated social fund expenditure (well over 90 per cent out of a total spend of £195 million in 2013/14) covers the cost of the universal winter fuel payment (ibid). The SNP government has pledged not to abolish, cut or means test the winter fuel allowance, and it is currently consulting on whether to extend eligibility to others below the age of 62 who may be at risk of fuel poverty (Scottish Government 2015e).

2.3.12 Universal credit

The Scotland bill will devolve some administrative powers over particular aspects of universal credit (UC) – the new working-age benefit that rolls together existing means-tested benefits into one payment. The Scotland bill will devolve the power to vary how payments are made (such as the frequency and to households – individuals and landlords), as well as to vary the housing costs element of UC such as the under-occupancy charge – often referred to as the 'bedroom tax' – and local housing allowance rates. Beyond abolishing the under-occupancy charge, the Scottish government has not indicated how it would use these new powers (ibid).

2.3.13 Power to 'top-up' other reserved benefits and create new devolved benefits

The Scotland bill proposes that the Scottish parliament be given the power to make discretionary payments in any area of welfare, as well as to create new benefits in areas of devolved responsibility, so long as it is fully funded by the Scottish government. If the Scotland bill and fiscal framework operate as intended, top-up payments and new devolved benefits should not lead to an offsetting reduction in an individual's entitlement to benefits or post-tax earnings.[1]

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Taken together, following the full delivery of the Smith commission proposals, it is estimated that government in Scotland (across both local and national government), will have control over or be assigned revenue totalling 48 per cent of their spending. Income tax will be by far the most significant revenue change, totalling a quarter of all devolved spending. As a proportion of total revenue collected in Scotland (onshore), the Smith commission's tax proposals total 41 per cent (Scottish Government 2015f).

1 There are some exclusions, such as those individuals who have been sanctioned, but even then the Smith proposals allow for top-ups under 'exceptional circumstances'.

Table 2.1
Devolved revenue sources 2013/14 (£m and as a proportion of devolved expenditure)

	Devolved revenue	% of devolved expenditure
Income tax liabilities	£10,911m	25%
Stamp duties	£385m	1%
Air passenger duty	£251m	1%
Landfill tax	£105m	0%
Aggregates levy	£50m	0%
Non-domestic rates	£1,927m	4%
Council tax	£1,941m	4%
VAT (assigned)	£5,030m	12%
Total devolved revenue	**£20,600m**	**48%**
Total devolved expenditure	**£43,334m**	-

Source: Scottish Government, 'Government Expenditure & Revenue Scotland' (Scottish Government 2015f)

The devolved benefits being proposed totalled £2.5 billion in 2013/14 (ibid), or 15 per cent of total benefit expenditure in Scotland (DWP 2015). Key benefits not devolved include the state pension (total spend of £7 billion in 2013/14), tax credits (£2 billion), housing benefit (£1.7 billion), and employment and support allowance (£1.2 billion).

2.4 General principles and the fiscal framework

Beyond specific taxes and benefits earmarked for devolution, there are several overriding principles stemming from the Smith commission that, if fully implemented in the Scotland bill, will impact both on the Scottish government's ability to use its new powers and on fiscal transfers from the UK government to Scotland.

2.4.1 Economic responsibility

The Smith commission states that delivery of its proposals 'should result in the devolved Scottish budget benefiting in full from policy decisions by the Scottish Government that increase revenues or reduce expenditure, and the devolved Scottish budget bearing the full costs of policy decisions that reduce revenues or increase expenditure' (Smith Commission 2014). In the first instance, this guarantees that any changes to income tax on earnings or benefit rates in Scotland will only affect the devolved Scottish budget. It also suggests that changes to income tax or benefit rates that may have a resulting impact on other, reserved revenues or spending will require additional fiscal transfers from Scotland to the rest of the UK, or vice versa.

2.4.2 No detriment

The Smith commission also introduces the important 'no detriment' principle in relation to the devolution of new powers to the Scottish parliament, which includes two requirements. First, 'that the Scottish and UK governments' budgets should be no larger or smaller simply as a result of the initial transfer of tax and/or spending powers' (ibid). This means that when a spending power (such as over a particular benefit) is devolved, there should be an increase in the Scottish block grant equal to how much is currently spent on that policy in Scotland. Likewise, the devolution of powers over a particular tax will lead to a reduction in the Scottish block grant equal to the revenue currently collected from that tax in Scotland. Second, the no detriment principle also requires that 'where either the UK or the Scottish government makes policy decisions that affect the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving' (ibid). This has important implications for analysing UK and Scottish government decision-making post-devolution, since there is potential for the UK government's use of reserved powers to affect tax receipts and, by extension, expenditure in Scotland. In addition, were the UK government to raise or reduce reserved taxes in order to raise or reduce expenditure on devolved areas of policy, the workings of the Barnett formula mean that this could lead to an increase or reduction in Scottish government funding, without mechanisms in place to satisfy the no detriment principle.

Finally, the Smith commission calls for an updated 'fiscal framework' for Scotland, to agree the method by which the Scottish parliament's block grant will be adjusted upon the immediate devolution of the Smith commission powers, as well as how it will be indexed in the following years. Alongside this, the new fiscal framework will govern the new borrowing powers available to the Scottish government and a set of fiscal rules over borrowing and debt which the Scottish government must follow.

3.
TAX AND BENEFIT PRESSURES IN SCOTLAND

Any discussion around the Scottish government using its new powers over tax and benefits must take into account the wide-ranging tax and benefit reform programme of the current UK government. At a UK level, the government has announced significant changes to the tax and benefit system that will have an impact on Scottish households and on the fiscal position of Scotland. Beyond announced measures, a number of the UK government's manifesto commitments in relation to the tax-benefit system could have a huge impact on tax and spend in Scotland over the rest of this parliament and beyond.

In addition, the devolution of tax revenues comes with significant additional risks and opportunities. Since the inception of the Scottish parliament in 1999, the vast majority of the Scottish government's income was determined by decisions over public spending at a UK level, through the operation of the Barnett formula. While hardly free of fluctuations, especially in recent years, following the current phase of devolution a much greater proportion of the Scottish government's funding will instead be tied to fluctuations in the Scottish economy and demographic trends in Scotland.

3.1 The UK government's tax and welfare programme

This section quantifies the impact of the UK government's tax and benefit programme, for most of the major changes announced across the 2015 summer budget and autumn statements, and therefore the costs of reversing them using the new tax and benefit powers being devolved through the Scotland bill.

The key changes modelled are:

- **Freezes to the value of most working-age benefits:** working-age benefits (excluding those relating to sickness and disability) will be frozen for four years from April 2016.
- **Cuts to universal credit (UC) work allowances:** the point at which in-work benefits start to be withdrawn will be lowered from April 2016. The level of earnings at which UC awards start to be withdrawn will fall from its current level of £4,764 for those with housing costs and £2,304 for those with housing costs, and removed entirely for those without children.
- **A reduction in the value of the benefit cap:** the total amount of income a family can receive from benefits will be capped at £20,000 per year, down from £25,000 a year currently.
- **Changes to family element in universal credit:** for new claims and new births, the family element in universal credit will be eliminated entirely, and for new claims the child element will be restricted to two children.[2]

2 In our modelling, we have only estimated the restriction on the family element for new children born after April 2017, assuming the same demographic structure in 2020 as in our base data (2011–13). It is not possible to estimate the impact of family element restrictions for new claims, due to the lack of information currently on on-flows into universal credit and length of claims as it is still being rolled out. Therefore our modelling is likely to underestimate the impact of this change.

- **Rise in personal allowance and higher rate threshold:** the tax-free personal allowance will rise to £11,000 from April 2016, higher than the previously planned £10,800, and will increase to £11,200 in April 2017. Unlike in recent years, all the benefits from this rise will be passed on to higher rate taxpayers, with the higher rate threshold – the point at which earners begin paying the higher rate of tax – rising to £43,000 in April 2016 and £43,600 in April 2017.
- **The 'national living wage':** from April 2016, a new minimum wage for those aged over 25 will be introduced. This will rise over time to 60 per cent of median hourly pay by 2020, expected to be £9.35 an hour.

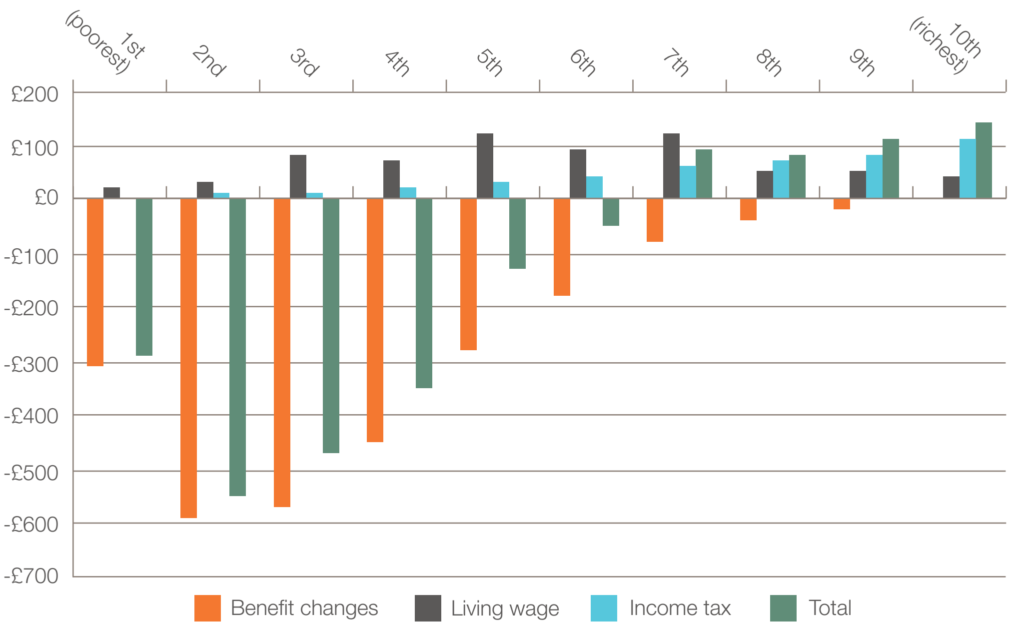
We have modelled these changes in April 2020, when we assume universal credit has been fully rolled out and the national living wage has reached £9 per hour.

3.2 Impact on Scottish households

By April 2020, most Scottish households claiming working-age benefits, other than those relating to disability, will see their income fall. Figure 3.1 shows how Scottish households in each decile of the income distribution will see their net income change as a result of these changes. The greatest losses will be seen in the second decile, where households will lose an average of £590 a year from the benefit changes. Across the bottom 40 per cent of the income distribution households will lose on average more than £300 a year.

These changes will only be partially mitigated by the cut in income tax through the increased personal allowance and higher rate threshold, and the introduction of the national living wage. While those in the 7th and 8th deciles will see a small net gain of around £100, those in the top decile will gain on average £140. Those households in the 6th decile and below will see a fall in their income, even after accounting for the gains they receive from income tax and the introduction of the national living wage.

Figure 3.1
Households in the 2nd decile will be the biggest losers of these tax-benefit changes
Distributional impact of announced changes to tax, benefits and the introduction of the national living wage in 2020/21 (in 2015/16 prices), by household income decile (before housing costs)



Source: IPPR Scotland tax-benefit model

Taken as a whole, we find that 700,000 Scottish households will lose out as a result of these changes. These households will lose an average of £730 a year. Conversely, 1.4 million households will gain an average of £180 a year from a combination of the cut to income tax, rise in the personal allowance and higher rate threshold, and the introduction of the national living wage.

In terms of the fiscal impact, a total of £500 million will be withdrawn from Scotland as a result of these changes. This comes from cuts to benefits (£600 million), offset by £100 million from the tax cuts through the increased personal allowance and higher rate threshold.

Challenge: What, if anything, should the Scottish parliament do to reverse UK-wide benefit cuts in Scotland?

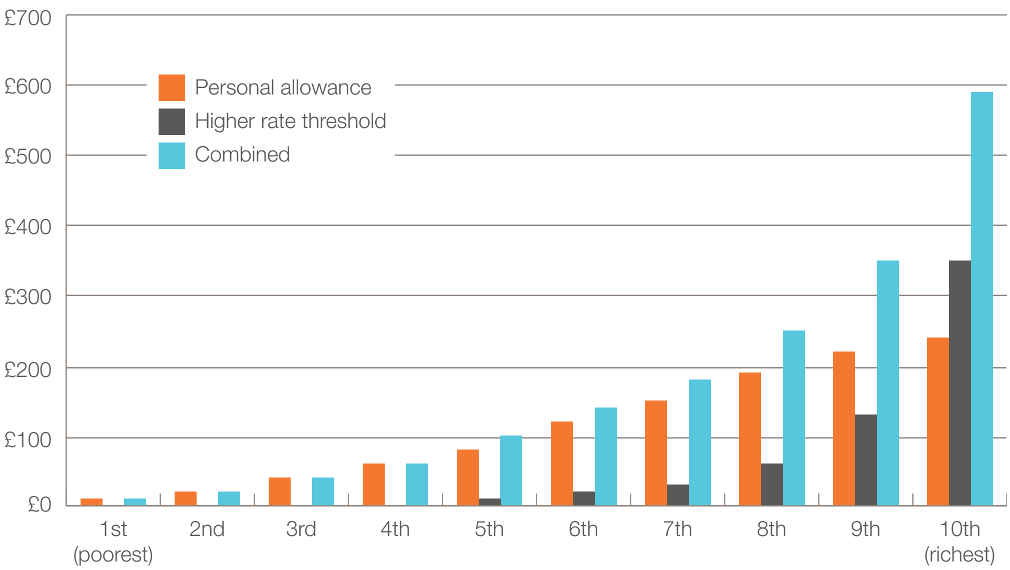
3.3 UK Conservative manifesto tax commitments

Beyond the changes already announced at a UK level, the following two changes to tax that were in the UK Conservative manifesto and are expected to be implemented at some point in the current parliament.

- **Personal allowance**: the personal allowance will rise to £12,500 by the end of this parliament, up from its current level of £10,600 (2015/16).
- **Higher rate threshold**: the point at which individuals begin to pay the higher rate of income tax will rise from its current level of £42,385 (2015/16) to £50,000.

The UK government has already passed through parliament the first rises in both the personal allowance and higher rate threshold – the former will rise to £11,200, and the latter to £43,600, in April 2017.

Figure 3.2
The highest earners will be the biggest winners of the tax changes
Distributional impact of planned changes to tax thresholds in 2020/21 (2015/16 £),[3] by household income decile (before housing costs)



Source: IPPR tax-benefit model

3 Personal allowance increase shown with the higher rate threshold rising by CPI, higher rate threshold increase shown against a personal allowance of £12,500. Changes shown are relative to a baseline of scheduled changes to personal allowance and higher rate threshold (seeing them rise to £11,200 and £43,600 respectively in 2017/18), with CPI uprating thereafter.

Figure 3.2 shows the distributional impact of subsequent increases in the personal allowance to £12,500 and the higher rate threshold to £50,000, relative to where they would fall in 2020/21 if uprated in the years after 2017 by consumer price inflation (£11,850 and £46,130 respectively).

While those across the income distribution in Scotland will benefit from these changes to tax, with 1.5 million Scottish households gaining an average of £280 a year by 2020/21, the biggest winners will be those at the top of the earnings distribution, who will gain £590 a year on average. The poorest 40 per cent of households are expected to gain less than £100 on average from the rise in tax thresholds.

It is also important to note that those claiming universal credit, which is means tested on net income, and earning above the universal credit work allowance, will not receive the full benefit of these tax cuts as the rise in their net earnings will lead to a reduction in their UC award.

Turning to the fiscal impact, these changes are expected to lead to a net reduction of £500 million a year in revenue collected in Scotland by 2020/21, with £300 million lost through the personal allowance increase, and a further £300 million from the higher rate threshold. The cost of increasing the higher rate threshold in Scotland to £50,000 would be offset by a £100 million increase in Scottish national insurance (NI) receipts. Extra revenue gained through NI is generated since the point at which the rate of contributions falls from 12 to 2 per cent is tied to the higher rate threshold, although as NICs is not being devolved this fiscal offsetting will accrue to the UK government. If the fiscal framework operates as intended, it is likely that the Scottish parliament's budget will be insulated from the costs of increasing the personal allowance in Scotland as it is a reserved power. However, the full costs of increasing the higher rate threshold are likely to fall on the Scottish parliament without increased NI receipts to offset this.

Challenge: Given UK government plans to increase the higher rate threshold to £50,000, at what level should the higher rate and additional rate thresholds be set for higher earning Scottish taxpayers?

3.4 Challenges of fluctuations in revenue in Scotland

A second set of risks and opportunities faced by Scotland under a more devolved system of taxes and benefits concerns how growth in devolved sources of revenue will be tied more closely to how Scotland performs in economic and potentially demographic terms. Currently, the vast majority of the Scottish government's income is dictated by spending decisions taken by the UK government, with little relation to economic and demographic developments in Scotland. Depending on how the fiscal framework operates in practice, devolution of half of tax revenues collected in Scotland, while not breaking this link entirely, should instead tie the funding available to the Scottish government much more closely to changes within Scotland, decoupling more of Scotland's budget from spending decisions in the rest of the UK.

This section analyses how diverging trends in two key areas may impact on the fiscal position of the Scottish government.

- **Earnings:** fluctuations in the earnings of Scottish workers will have an impact on the tax base in Scotland.
- **Demography:** in terms of revenue, differences in the growth rate of the working population are likely to exert an impact on the tax base (and the cost base).

3.4.1 Earnings

Since 2011, median earnings in Scotland have grown much faster than in the UK as a whole. Median weekly gross earnings in Scotland rose between 2011 and

2015 by 8.7 per cent, versus 5.9 per cent in the UK as a whole (ONS 2015a). This divergence in earnings growth differs from earlier years; between 2007 and 2011 growth in median weekly gross earnings was 11 per cent in Scotland versus 9 per cent in the UK, and between 2000 and 2004 earnings growth was slightly slower in Scotland. Small fluctuations in earnings growth of this kind can, over several years, have a significant impact on tax revenue.

Between 2015/16 and 2019/20, the Office for Budget Responsibility (OBR) expects average earnings in the UK to grow by 16 per cent (OBR 2015). In order to test how fluctuations around this figure may impact on tax receipts in Scotland we have modelled Scottish income tax receipts in 2020 where average earnings growth in Scotland outperforms the UK by two and by four percentage points, and where earnings growth in Scotland underperforms that in the UK by the same amounts.

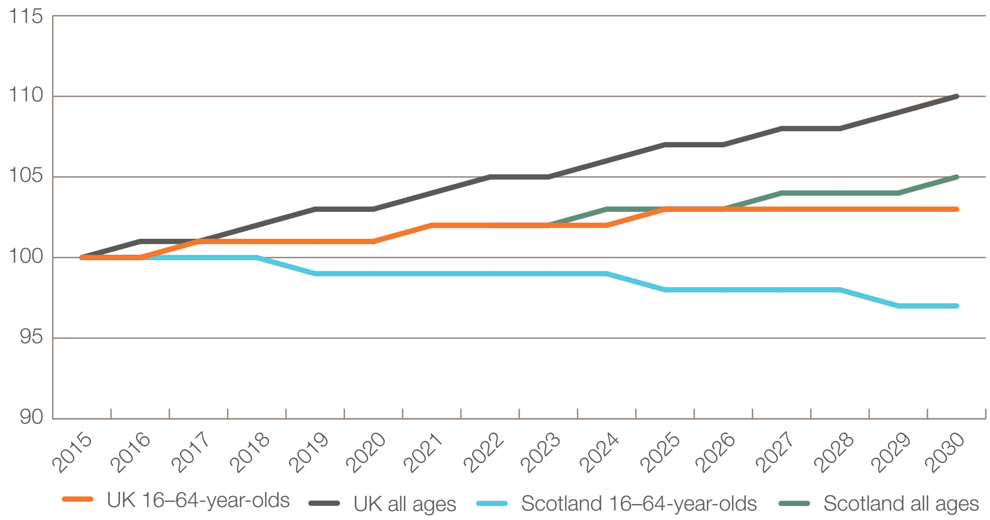
This shows that, for every two additional percentage points in pay growth in Scotland relative to the UK as a whole, income tax revenues in Scotland are likely to be £400 million higher annually. Were Scotland to underperform relative to the UK by 2 percentage points, tax revenues would be £400 million lower annually.

Challenge: What should the Scottish parliament do to boost earnings in Scotland, at least in line with UK-wide earnings increases?

3.4.2 Demography

The rate of growth in the working-age population and their employment rate will also have an impact on Scottish tax revenues in the future. At the same time, changes in the population of older individuals will influence pressures on public services in Scotland, given that older people are more likely to use public services such as the NHS and social care. Demographic forecasts suggest that between 2015 and 2020 the overall population of Scotland will grow at a slower rate than that of the UK as a whole, increasing by 1.5 per cent versus 3.5 per cent in the UK as a whole (ONS 2015b). However, the working-age population in Scotland is expected to shrink by 0.6 per cent over the same period, whereas in the UK as a whole it is expected to rise by 1.4 per cent.

Figure 3.3
The working-age population is set to decline in Scotland but rise in the UK as a whole
Projected growth in overall and 16–64-year-old population, 2015–2030, UK and Scotland (2015=100)



Source: ONS, 'National population projections, 2014-based Statistical Bulletin' (ONS 2015b)

Assuming that the employment rate stays constant, the decline in Scotland's working-age population is likely to lead to tax receipts being £300 million lower annually by 2020/21, relative to tax receipts if population growth matched that of the UK as a whole. How much of this financial risk rests with Scotland will depend on the implications of the fiscal framework agreed between the Scottish and UK governments, and how that framework operates over the medium to long term.

This pattern is expected to continue through the 2020s (see figure 3.3), with the overall UK working-age population rising by 3.0 per cent by 2030, but a fall of 3.3 per cent in the working-age population in Scotland.

Challenge: What should the Scottish government do to grow the working-age population in Scotland, at least in line with growth in the rest of the UK?

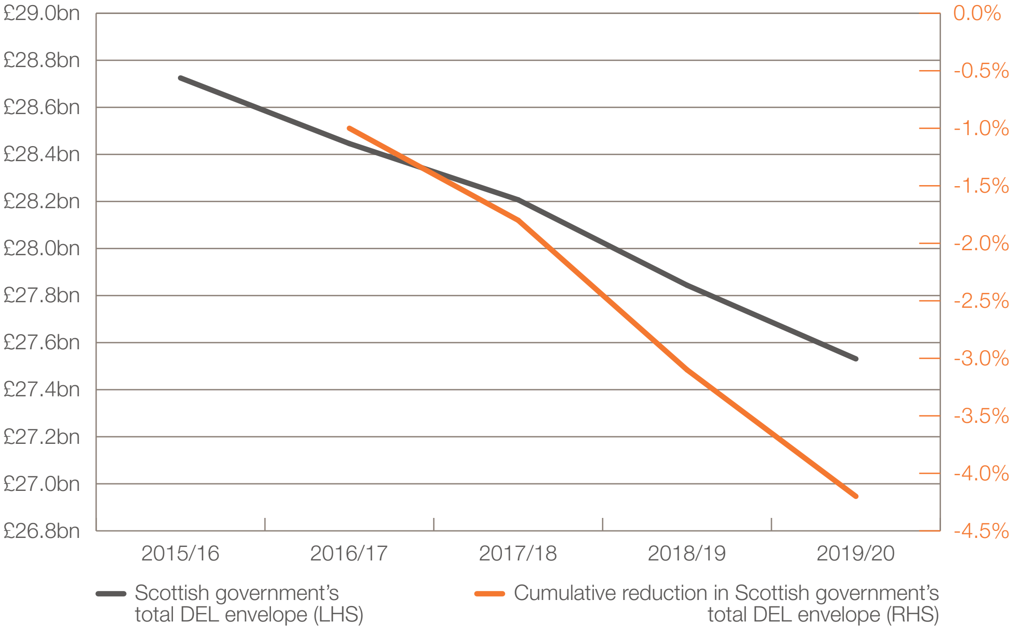
3.5 Fiscal challenges facing Scotland

As well as the potential implications of UK government planned tax cuts, the Scottish government faces faces a more immediate challenge in that cuts to UK-wide spending in the coming years will lead to a reduction in the block grant received by the Scottish government from the UK.

The Scottish government's draft budget, published in December 2015, presented its estimate of the spending reductions required over the next four years. It found that, due to cuts in the block grant, total spending would need to fall by £1.2 billion, or over 4 per cent, between 2015/16 and 2019/20.

Challenge: What should the Scottish parliament do, if anything, to reverse public spending cuts coming to Scotland over the coming years?

Figure 3.4
The Scottish government estimates total spending will need to fall by over 4 per cent by 2020
Expected change in Scottish government spending (in 2015/16 prices and as cumulative % reduction), 2015/16 to 2019/20



Source: Scottish Government, 'Scottish budget draft budget 2015-16' (Scottish Government 2015g)

This picture may change when the Scotland bill's proposals and the fiscal framework are fully implemented. At the point at which the full suite of tax revenues set out in the Scotland bill have been devolved, there will be a corresponding reduction in the size of the block grant to the Scottish government, accompanied by an increase in the block grant to take account of new welfare powers.

However, how the block grant will be adjusted in future years is equally important, if not more so, and led to considerable debate as the UK and Scottish governments negotiated the newly agreed fiscal framework. While it is expected that the Barnett formula will still calculate the gross level of the remaining block grant, this will then be changed using a 'block-grant adjustment' (BGA), the impact of which varies considerably between methods.

There are three approaches under discussion.

- **Indexed deduction** would calculate the size of the BGA according to the percentage change in devolved tax revenues in the rest of the UK.[4]
- **Per capita indexed deduction** calculates the size of the BGA according to the percentage change in devolved tax revenues per capita in the rest of the UK.[5]
- **Levels deduction** calculates the size of the BGA according to the population share of the change in the rest of UK revenues.[6]

The agreed fiscal framework will see funding for Scotland calculated on an equivalent of percapita indexed deduction. This will be reviewed by 2020. In a paper on the different methods, the Institute for Fiscal Studies found that the indexed deduction approach would expose Scotland to the risk that population growth in the rest of the UK would be faster than in Scotland, because it is based on change in overall devolved tax revenues, which are tightly linked to population growth (Bell et al 2015). Although Scotland would also disproportionately benefit if population growth in Scotland was higher, this is not expected to happen (as set out in figure 3.3).

Under per capita indexed deduction the opposite is true, with faster population growth in the rest of the UK not impacting on the size of the block grant adjustment. The levels deduction approach follows a similar logic and is consistent with the Barnett formula.

There are different estimates of the impact each method would have on the size of the BGA, although generally they find that the per capita indexation approach would provide the greatest funding to Scotland over the coming years, due to negating the effects of expected slower population growth in Scotland. Levels deduction is likely to cause the biggest reduction in Scotland's block grant, since the rest of the UK has a higher starting point for devolved tax revenues, therefore any percentage increase in those revenues would lead to higher growth in cash terms and a larger corresponding reduction in the black grant. Indexed deduction would lead to a similar but less pronounced pattern of block grant adjustment, as it is based on percentage change.

The IFS found that if these three different approaches had been used over the period 1999–2013 for income tax, per capita indexed deduction would have led to the Scottish government budget being £1 billion higher in 2013, indexed deduction £500 million higher, and levels deduction around £500 million lower.

4 For example, a 1 per cent rise in devolved revenues in the rest of the UK would lead to a 1 per cent deduction in the BGA.

5 Under per capita indexed deduction, a 1 per cent rise in devolved revenue per head in the rest of the UK would lead to a 1 per cent increase in the BGA.

6 For example, a £10 billion increase in devolved revenues in the rest of the UK would, assuming Scotland's population equals 9 per cent of the population in the rest of the UK, lead to an increase in the BGA of £900 million (equivalent to reducing the block grant by the same amount).

It is also important to consider how different methods for calculating the BGA interact with income tax policy decisions at a UK level. For example, as already noted, the UK government plans to raise the personal allowance to £12,500 over this parliament. This will lead to a reduction in Scottish tax revenues of around £300 million per year by 2020/21, relative to revenues if the personal allowance rises by inflation. But it will also lead to a reduction in tax revenue in the rest of the UK, with a knock-on impact on the size of the block grant adjustment which should fully insulate Scotland's budget from reductions in Scottish tax revenues from reserved tax decisions. It will be important to understand whether the fiscal framework will ensure the reimbursement of reserved decisions over the personal allowance, and other reserved elements of tax, to Scottish devolved budgets.

4.
THE FISCAL AND DISTRIBUTIONAL IMPACT OF SCOTLAND'S TAX AND BENEFIT POWERS

As it stands, Scottish households face a further five years of cuts to key welfare benefits, including the new universal credit that will adversely affect those at the bottom of the income distribution. This will see reductions in benefits worth £600 million per year by 2020/21 compared to the expected value and eligibility rules of benefits in 2020/21 before changes announced in the 2015 summer budget and autumn statement.

In addition, the UK government is planning significant tax cuts, through personal allowance and higher tax rate threshold increases, that stand to benefit those households with the highest incomes the most. The increased personal allowance will see a reduction in income tax revenues of around £300 million from Scottish taxpayers by 2020/21 (though if the fiscal framework operates as intended Scotland's budget should be insulated from these reductions in Scottish tax revenues). Under the powers devolved through the Scotland bill, if the Scottish parliament matches UK government plans to increase the higher rate threshold to £50,000 this will also see a reduction in Scottish tax revenues of £300 million per year by 2020/21. If the fiscal framework operates as intended then, as this is a devolved decision, the cost would be fully borne by Scotland's budget

At the same time, there are substantial fiscal pressures facing the Scottish government. Under the existing spending framework the Scottish block grant is due to reduce by £1.2 billion by 2020/21. With real-terms increases for NHS budgets, non-protected departments are likely to see more significant spending cuts. These pressures may be compounded by the fiscal framework agreement and how the future indexation of the block grant responds to demographic change and economic divergence between Scotland and the rest of the UK.

In Scotland, in recent months, attention has focused on whether tax rises, under new or existing powers, could be used to reduce or fully eliminate the need for cuts to benefits or public services in Scotland. In the run-up to the 2015 autumn statement, this debate focused on how the Scottish parliament could mitigate against cuts to tax credits through the use of top-up payments, provision for which was included in the Smith commission and Scotland bill. While the tax credit cuts were subsequently cancelled in the autumn statement, there remain a number of welfare cuts going ahead, as outlined above, and the options available to policymakers for reducing this impact should be considered.

This chapter explores how the Scottish parliament's new powers over income tax and over welfare, stemming from the Scotland bill, could be used in Scotland to address these concerns. In addition, we explore the likely distributional and fiscal impact of some existing fiscal powers.

4.1 Income tax

As outlined above, it is expected that from April 2017 the Scottish parliament will have full control over income taxation as it applies to earnings above the tax-free personal allowance, including the basic, higher and additional rates of income tax, as well as the bands over which these rates operate. It could also add bands or remove bands.

This affords the Scottish government considerable flexibility over the taxation of labour earnings. However, income from savings and dividends will remain reserved. Here we consider the fiscal and distributional impact of a variety of changes to income tax rates and thresholds that a future Scottish government could implement.

4.1.1 Income tax rate changes modelled for Scotland

- **1p on basic rate:** an increase of 1 percentage point in the basic rate of income tax, payable on income between the personal allowance and the higher rate threshold and currently 20 per cent
- **1p on higher rate:** an increase of 1 percentage point in the higher rate of income tax, payable on income between the higher rate threshold and the additional rate threshold, and currently 40 per cent
- **the existing Scottish rate of income tax:** an increase of 1 percentage point in the basic rate, the higher rate, and the additional rate of income tax (paid on earnings over £150,000 and currently 45 per cent).

There are 2.5 million income tax payers in Scotland, of which the majority (2.1 million) have earnings between the personal allowance and higher rate threshold and therefore only pay the basic rate. There are a further 0.4 million higher rate taxpayers, and 17,000 additional rate taxpayers (HMRC 2015).

Here, we analyse the projected impact of these changes in April 2020, and assume that the UK government's announced changes to the personal allowance and higher rate threshold have taken place – that is, rises in the former to £11,200 and the latter to £43,600 by 2017/18. In subsequent years we assume that the personal allowance follows its manifesto-planned but as yet unannounced increase to £12,500 and the basic rate limit (the gap between the personal allowance and the higher rate threshold) is indexed in line with the OBR's estimate of Q3 CPI inflation.[7] Because of the small sample size of additional rate taxpayers in the Family Resources Survey, we have not analysed changes to the additional rate of income tax, as these would not be sufficiently robust to calculate, however it is possible to calculate in aggregate the impact of changes to the additional rate threshold (see below).

At an aggregate level, 1.6 million households in Scotland would lose an average of £220 a year from an increase of 1p on the basic rate. An increase in the higher rate would hit a smaller number of households (400,000), but those affected would lose an average of £300 a year. This then rises to 1.7 million households losing an average of £330 a year from an increase of 1p across all bands.

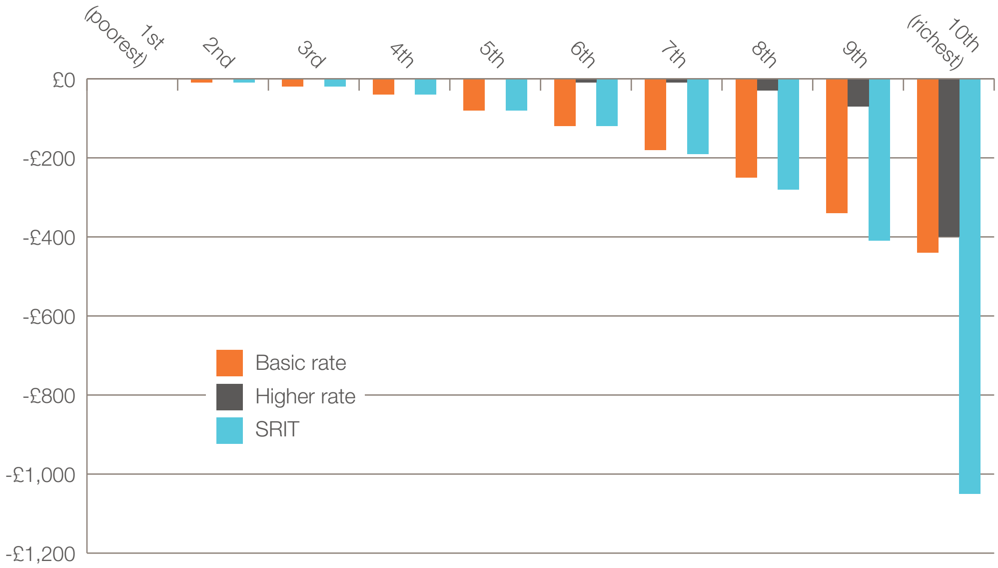
In distributional terms, a rise in the basic rate of 1p has no impact on the poorest 10 per cent of households, who are not earning enough to pay income tax, but would lead to small losses in net income for the poorest 2nd to 4th deciles of between £10 and £50 respectively. The biggest losers are those in the top 10 per cent of households, who would lose £440 on average. A 1p increase in the higher rate has no impact on the bottom half of the household income distribution, and only a very small loss for the 6th–8th deciles, approximately

7 While the UK government plans to increase the higher rate threshold to £50,000 by 2020/21, it will be at the discretion of the Scottish government whether to pass this on to Scottish taxpayers or not. We index in line with the OBR's estimate of third quarter CPI inflation as set out in the UK Income Tax Act, which states that September CPI should be used as the basis for indexation of tax bands.

£20 a year on average. Those in the richest 10 per cent of households would, on the other hand, lose £400 a year on average.

A 1p increase across all current rates of income tax in Scotland combines the impact of both measures, with a small number of households in the top decile also affected by the 1p increase in the additional rate, increasing average losses to over £1,000 a year.

Figure 4.1
The highest earners would lose on average over £1,000 with a 1p increase in the basic and higher rates
Distributional impact of increasing income tax rates by 1p in 2020/21 (2015/16 £), by household income decile (before housing costs)



Source: IPPR Scotland tax-benefit model

In revenue terms, a 1p rise in the basic rate of income tax would raise £400 million, a 1p increase in the higher rate would raise £100 million, and a 1p increase across all current tax rates would raise £500 million.

4.1.2 Income tax thresholds

Beyond the power to change the rates of income tax, the Scottish parliament will also gain control over income tax thresholds and therefore income tax bands. There are two existing income tax thresholds over which the Scottish parliament will have control (though entirely new bands and thresholds could be implemented).

- **The higher rate threshold** (HRT) is the amount of income that can be earned before income is taxed at the higher rate of 40 per cent, set at £43,000 from April 2016. The basic rate limit (BRL) is related to the HRT in that it is used to describe the range of income over which the basic rate applies: the difference between the HRT and the tax-free personal allowance. As of April 2016 the personal allowance will be £11,000, the BRL will be £32,000, and therefore, as stated, the HRT will be £43,000.
- **The additional rate limit is** the amount of earnings that can be earned before paying the additional rate of 45 per cent, currently set at £150,000.

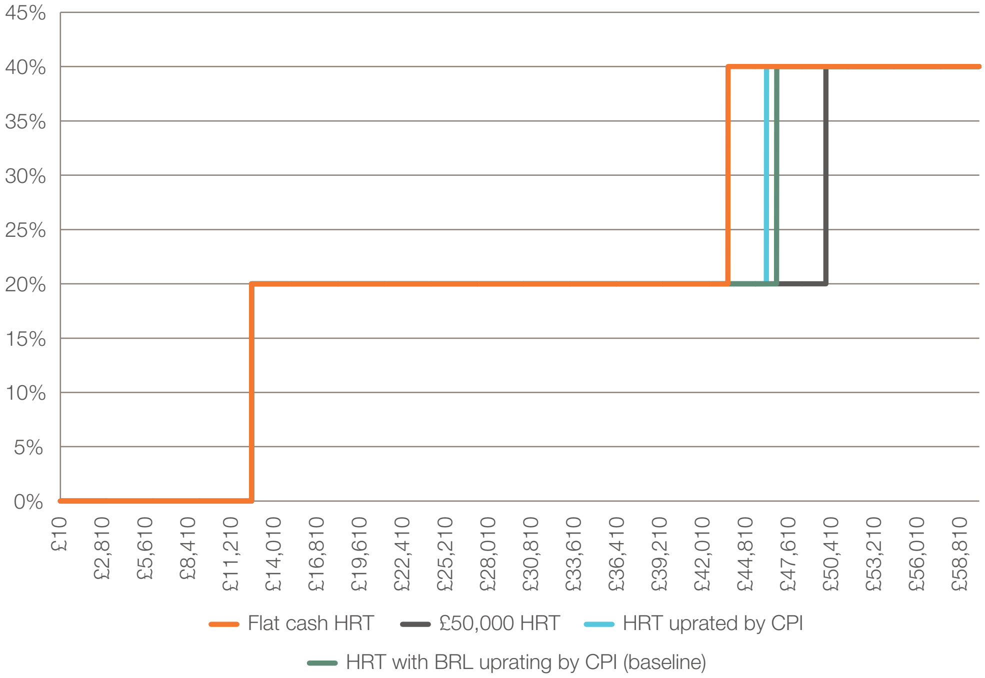
As outlined above, the Scottish parliament will have no control over the personal allowance. In revenue terms, though, the impact of moving the personal allowance is significant. If the UK government does increase the personal allowance to £12,500 as planned by 2020/21, this would see tax revenues in Scotland fall by £300 million per year. However, if the fiscal framework operates as intended, Scotland's budget should be insulated from reductions in Scottish tax revenue from reserved tax decisions

We have modelled three alternative choices for indexation of the higher rate threshold–basic rate limit. We have modelled these changes assuming the personal allowance rises to £12,500 as planned by the UK government.

- **Uprating the HRT in line with CPI:** the Scottish government may choose to increase the higher rate threshold in line with price inflation. This would see the HRT rise from £43,000 in 2016/17 to £46,120 in 2020/21.
- **Freezing the higher rate threshold in cash terms:** a freeze in the HRT would reduce the BRL over time as the personal allowance rises. This would see the HRT held at £43,600 in each year between 2017/18 and 2020/21.
- **Delivering a £50,000 higher rate threshold:** the UK government plans to increase the higher rate threshold to £50,000 by the end of this parliament (2020). Under new powers, the Scottish government could choose to match this for Scottish taxpayers.

Figure 4.2 shows the impact each of these thresholds would have on the marginal tax rate schedule for employment earnings, relative to where the HRT would fall if the BRL is uprated in line with CPI (implying above-inflation increases in the HRT because the personal allowance is rising faster than inflation to £12,500). This sees the HRT rise to £46,780 by 2020/21. Increasing the HRT in line with CPI or fixing it in cash terms would see a less generous HRT than the 'business-as-usual' case, shifting the point at which earners start to pay tax at the higher rate to a lower level of employment earnings. Conversely, a £50,000 HRT would imply a substantial increase in the point at which individuals start to pay income tax at the higher rate.

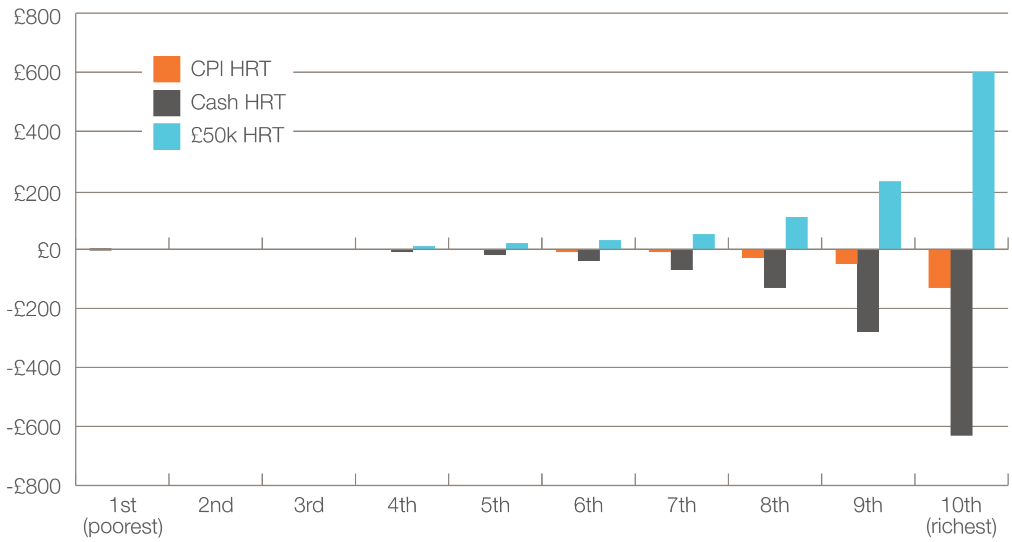
Figure 4.2
Decisions on uprating HRT will affect the level of income beyond which individuals pay tax at the 40 per cent rate
Marginal tax rate schedule under different options for uprating the basic rate limit – higher rate threshold



Source: IPPR (author's calculations)

Figure 4.3 shows the distributional impact of these three uprating scenarios for the BRL–HRT in 2020/21, relative to a baseline where the BRL is uprated in line with inflation alongside a £12,500 personal allowance. Any change in the BRL–HRT has little impact on those in the bottom three deciles, with only those in the top 30 per cent of the household income distribution affected by more than £100 per year. Uprating the HRT in line with CPI has only a small impact on households, with those in the top 10 per cent, losing over £130 a year on average in 2020/21. If the higher rate threshold was fixed in cash terms, those in the top decile would lose £630 a year on average by 2020/21. Conversely, were the Scottish government to follow the lead of the UK government in increasing the higher rate threshold to £50,000, those in the top decile would see their income tax liabilities reduce by an average of £600 per year by 2020/21.

Figure 4.3
Uprating the higher rate threshold in line with CPI would have only a small impact on households
Distributional impact of uprating scenarios for the basic rate limit–higher rate threshold in 2020/21 (in 2015/16 prices), by household income decile (before housing costs)*



Source: IPPR Scotland tax-benefit model
***Note: relative to a baseline of CPI-indexation of basic rate limit and rise in personal allowance to £12,500. The upper earnings limit is fixed in these calculations, and so the results shown differ from those in chapter three for a £50,000 higher rate threshold.**

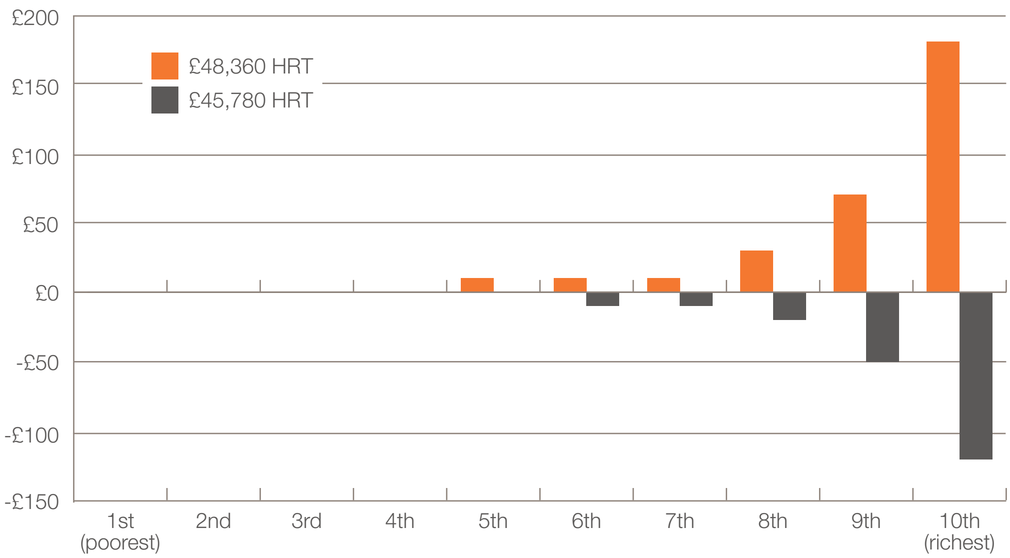
Decisions over the higher rate threshold will have a sizable impact on Scottish government revenue. Increasing the HRT by CPI indexation would increase Scottish tax revenues by £100 million per year in 2020/21, relative to a baseline increase. A freeze in the HRT in cash terms would increase Scottish tax revenues by £300 million per year (offsetting in full the reduction in Scottish tax revenues from the increased personal allowance). To match the UK government's plans to increase the HRT to £50,000 would cost £300 million per year by 2020/21.

Figure 4.4 outlines an alternative approach to deciding where the HRT should be drawn in Scotland. Given that earnings in Scotland are lower than across the UK as a whole, we looked at what an equivalent to the current HRT (indexed to CPI) would look like in Scottish terms by 2020/21, and what an equivalent to the proposed £50,000 HRT would look like in Scottish terms. This would ensure that a similar proportion of workers are affected by the HRT in both the UK and in Scotland.

In 2020/21, we estimate that in the UK as a whole approximately 14.7 per cent of those in work will have annual employment earnings greater than the planned £50,000 income tax threshold. Among Scottish earners, this falls to 13.4 per cent. Setting the Scottish level of the HRT at £48,360 would ensure that the same proportion of earners are subject to the higher rate of income tax on earnings in both Scotland and the UK as a whole. Alternatively, should the Scottish government decide not to pass on the full £50,000 HRT, they may wish to draw the threshold in line with the UK HRT under inflation uprating (£46,780) so that a similar proportion of earners pay the higher rate in both Scotland and the UK. This would imply lowering the HRT to £45,740, with 17.1 per cent of earners paying the higher rate.

As with other reductions in the HRT, this would primarily impact those households further up the income distribution. Were the Scottish government to increase the HRT to £48,360 (equivalent to a UK-wide HRT of £50,000), it would reduce Scottish tax revenues by £200 million (compared to £300 million for a £50,000 HRT in Scotland), and the gains to the top decile would fall from £600 on average to £180 per year. A higher rate threshold of £45,740 in 2020/21 (equivalent to the current UK-wide HRT, indexed with inflation) would see an increase in Scottish tax revenues of £100 million, with the top decile losing an average of £120 per year.

Figure 4.4
Setting the HRT in line with the Scottish earnings distribution will have the greatest impact on the highest-earning households
Distributional impact of aligning the HRT with the proportion of earners in 2020/21, by household income decile (before housing costs)*



Source: IPPR Scotland tax-benefit model
***Note: relative to a baseline of CPI-indexation of basic rate limit and rise in personal allowance to £12,500.**

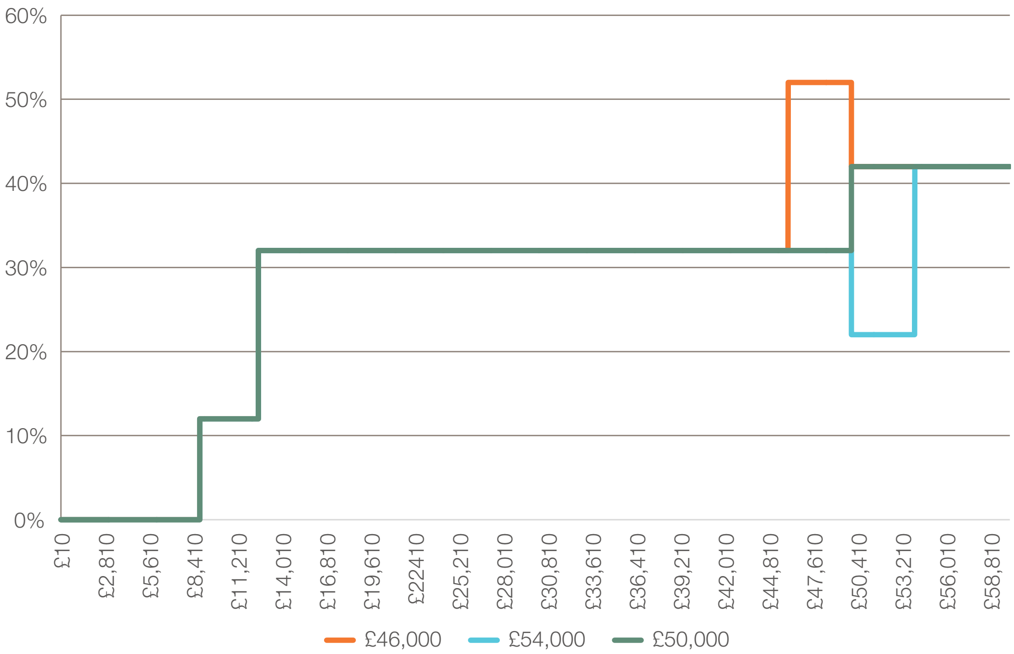
Table 4.1 summarises the impact of different methods of indexing the higher rate threshold on its level and fiscally in 2020/21.

Table 4.1
Indexation of the HRT, levels and fiscal impact (in 2015/16 prices)

	Level of the higher rate threshold in 2020/21	Fiscal impact (relative to baseline)
CPI indexation of the basic rate limit and £12,500 personal allowance (baseline scenario)	£46,780	–
CPI indexation of the higher rate threshold	£46,120	£100m
Flat cash higher rate threshold	£43,600	£300m
Higher rate threshold matches UK level	£50,000	-£300m
Drawn in line with proportion of earners in the UK earning more than baseline threshold	£45,740	£100m
Drawn in line with proportion of earners in the UK earning more than £50,000 threshold	£48,360	-£100m

How the higher rate threshold interacts with the upper earnings limit in national insurance – the point at which the marginal rate of national insurance contributions falls from 12 to 2 per cent – will have to be considered by policymakers in Scotland. Because at a UK level the upper earnings limit is tied to the level of the higher rate threshold, any reduction of the HRT in Scotland will lead to Scottish taxpayers facing a marginal tax rate of over 50 per cent on the portion of income earned between the Scottish HRT and the HRT in the rest of the UK (see figure 4.5). This means that any attempt to limit rises in the HRT in Scotland relative to the rest of the UK will have a perverse effect on the marginal tax rate of some earners, due to the interaction of the income tax and national insurance system. Conversely, were the Scottish government to want to increase the HRT to higher than its UK level, those with earnings between the two would enjoy a fall in their marginal tax rate from 32 to 22 per cent, before it then rises to 42 per cent, again altering the progressivity of the tax system.

Figure 4.5
Reducing the HRT in Scotland will have a perverse effect on the marginal tax rate of some earners
Marginal tax rate schedule (income tax plus national insurance) under a £50,000 HRT, a £54,000 HRT, and a £46,000 HRT, 2020/21



Source: IPPR (author's calculations)

Because of the small sample size of additional rate taxpayers in the Family Resources Survey, we have not analysed changes to the additional rate threshold, as these would not be sufficiently robust to model. At an aggregate level, we know that there are an estimated 17,000 additional rate taxpayers in Scotland (HMRC 2015). Were the additional rate threshold to be reduced by £10,000 in Scotland each of these additional rate taxpayers would pay an extra £500 in income tax per year, implying total revenue gains of £8.5 million per year. This may be an underestimate, depending on the number of Scottish individuals earning between £140,000 and £150,000, who would pay between £0 and £500 extra in income tax. However, this could be an overestimate if a significant number of additional rate taxpayers switch their incomes from earnings into savings or dividends.

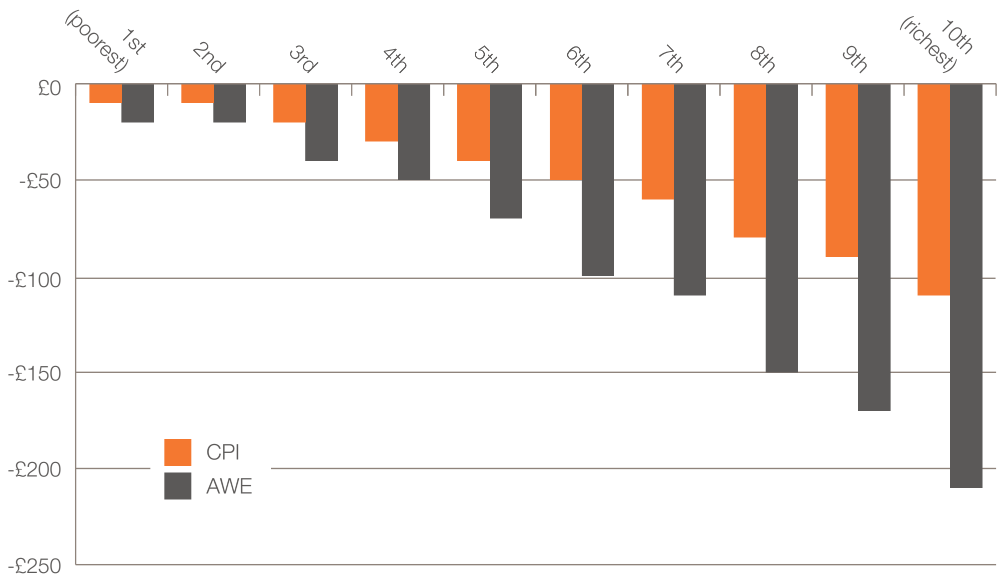
Challenge: How, if at all, should the Scottish parliament radically reform the income tax system in Scotland over the coming years?

4.2 Council tax

While the Scottish parliament does not have direct control over the council tax rates that local authorities in Scotland set, the Scottish government has worked with councils since 2007 to freeze council tax, providing revenue relief to councils in return through additions in grants. One revenue-raising option, albeit an indirect one, is for the Scottish government to end the council tax freeze and allow council tax to increase in line with wider economic trends. We have modelled two changes to council tax indexation in Scotland over this parliament:

- Increasing council tax rates in line with OBR forecasts of consumer price inflation (CPI)
- Increasing council tax rates in line with OBR forecasts of average earnings.

Figure 4.6
Higher earners would be the biggest losers from an increase in council tax
Distributional impact of uprating scenarios for council tax in Scotland in 2020/21 (in 2015/16 prices)



Source: IPPR Scotland tax-benefit model

Given that council tax is related to the value of the property in which a household lives, and that council tax reduction schemes offset the cost of the tax for those on lower incomes, the biggest losers from an increase in council tax would be those towards the top of the income distribution. We find that the richest decile of households would pay an extra £110 a year in council tax were it to be increased in line with CPI (a real-terms freeze) over this parliament, or £210 a year if increased in line with average earnings (see figure 4.6), compared to extending the current cash freeze in council tax. Those in the bottom decile, on the other hand, would pay an additional £10 and £20 respectively.

CPI uprating of council tax would raise £100 million a year for local government in Scotland, and increasing council tax in line with average earnings would raise £200 million. In each case there is a small offsetting effect from increased spending on the Scottish council tax reduction scheme.

4.3 Benefits

The Scottish government is expected to receive three sets of powers over the benefits system:

- full control over most working-age disability benefits
- the power to top-up reserved benefits through discretionary payments
- the power to introduce new benefit payments in areas of devolved competence.

We have modelled the fiscal and distributional impact of the following changes:

- increasing the current system of disability benefits in line with earnings rather than CPI inflation, so that they increase faster than they otherwise would over this parliament
- increasing the winter fuel allowance by earnings rather than CPI inflation, for the same reason
- reversal of planned UK cuts to benefits
- providing discretionary payments to top-up reserved benefits.

4.3.1 Reversal of planned UK cuts to benefits

The UK government has implemented cuts to in-work benefits that will come into force over the next few years. Given in-work benefits will not be devolved, a full or partial reversal of the cuts to in-work benefits would involve making discretionary payments to individual families, or using the Scottish parliament's as yet unclear top-up powers. Discretionary payments would require a clear delivery mechanism and application process.

We have modelled the reversal of two of the UK government's announced benefit cuts:

- **universal credit work allowances:** increasing the work allowances within universal credit to the levels expected before the summer budget (for couples, lone parents and those with disabilities) and restoring work allowances to single and couple adults with children
- **working-age benefit freeze:** returning to CPI-indexation for working-age benefits.

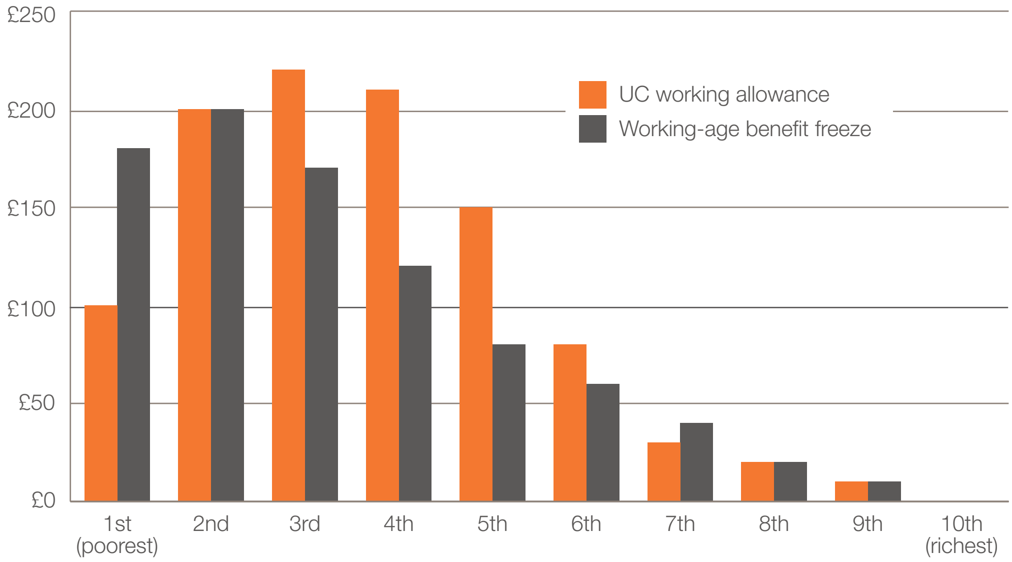
Figure 4.7 illustrates the distributional impact of these changes, showing that in general they benefit those in the bottom half of the income distribution. Reversing the benefit freeze is most advantageous to those in the bottom three deciles, with those in the second decile benefiting the most (an average of £200 a year across all households). Reversing the work allowances supports those in the second through fourth deciles the most, as it will help those in work and on low levels of earnings (rather than also benefiting those out of work like CPI-indexation of working-age benefits). In fiscal terms, a full reversal of the universal credit work allowances would cost £200 million per year by 2020/21, as would reversing the freeze on working-age benefits.

We estimate that around 200,000 households in Scotland would benefit from a reversal to UC work allowances, gaining on average £990 per year. A greater number would benefit from a return to CPI-indexation for working-age benefits (900,000), but their average gains would be lower at £230 per year.

Figure 4.7

The lowest earners would gain the most from reversing the benefit freeze

Distributional impact of reversing key benefit decisions (in 2015/16 prices), by household income decile (before housing costs)



Source: IPPR Scotland tax-benefit model

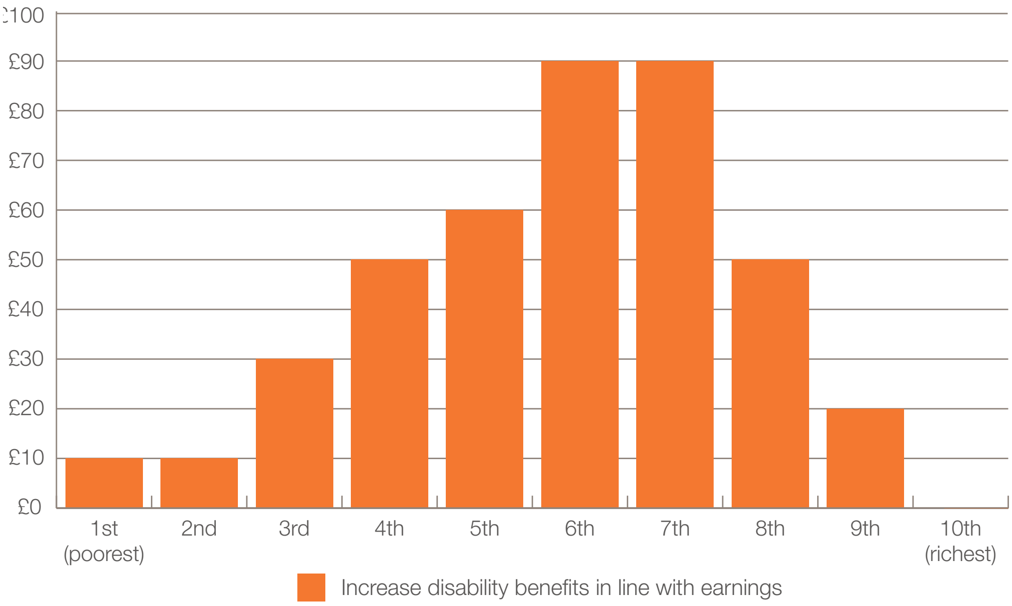
4.3.2 Disability benefits and winter fuel allowance

Changes to disability benefits and the winter fuel allowance are possible as they are benefits being fully devolved to the Scottish government. Uprating these benefits in line with earnings, rather than CPI, would be equivalent to an increase in their value of around 11 per cent by 2020/21. In our modelling we uprated the following disability benefits in line with earnings: attendance allowance, disability living allowance, severe disablement allowance, industrial injuries disablement benefit and carer's allowance. In addition, we model a similar uplift in winter fuel payments.

In fiscal terms, uprating disability benefits in line with earnings would cost £100 million per year by 2020/21. Increases in the rate of disability benefits would benefit 200,000 Scottish households, who would gain an average of £490 a year by 2020/21. The winter fuel allowance increase would benefit a similar number of households, but, because of the low level of the payment, each would only gain an average of £30 a year from the changes. The fiscal cost of increasing the winter fuel allowance is likely to be less than £10 million per year by 2020/21.

While households gaining from a rise in disability benefits are skewed higher up the income distribution (see figure 4.8), it should be noted that costs associated with disability are not taken into account when equivalising income across households, which only takes into account household size and composition in terms of adults and children. In addition, the income of households containing a disabled individual tends to be much lower before accounting for the income they receive from disability benefits; that is, one of the causes of the income distribution among disability claimants towards higher income deciles is the fact they receive disability benefits and these make up a significant portion of their income.

Figure 4.8
Disability benefit increases are skewed towards households higher up the income distribution
Distributional impact of increasing disability benefits in line with earnings to 2020/21 (in 2015/16 prices), by household income decile (before housing costs)



Source: IPPR Scotland tax-benefit model

4.3.3 Discretionary payment top-ups

To date, two specific discretionary payment top-ups have been discussed in Scotland. First, in the run-up to last November's autumn statement there was debate in Scotland about how and to what extent the Scottish government should reverse the cuts to tax credits that were announced in the 2015 summer budget, leading to a number of political parties in Scotland stating they would reverse the cuts through some form of discretionary payment.

However, it is expected that by 2020 the tax credit system will be fully phased out. So although the planned cuts to tax credits were reversed in the autumn statement, by the time the Scottish government gains the power to make these discretionary payments, it is likely that many more of those Scottish families claiming tax credits – and possibly the majority – will have migrated from the tax credits system to its replacement, universal credit. We therefore modelled the cost and feasibility of the Scottish government making a full or partial reversal of the cuts to the universal credit work allowance. We have modelled a full reversal through topping-up universal credit awards through Scotland bill powers (as set out above) or discretionary payments.

The Scottish parliament's expected top-up powers are as yet unclear. Discretionary payments would require a clear delivery mechanism and application process. Equally, while provision to top-up reserved benefits is made within the Scotland bill, there is still a lack of detail over how such payments will operate.

A particular concern, in either case, is whether any payment would count towards a household's income for means testing. If this were to be the case, then households could see any top-up or payment reduce their existing benefit entitlement, with the payment or top-up counting as income when calculating their benefit award. For example, a family expected to lose £100 per week through the cuts to the universal credit work allowance would, if a discretionary payment were made totalling

£100 per week, see their universal credit award reduced by £65, leaving them only £35 better off. This will be compounded if the rebate is treated as earnings, with taxpayer UC claimants losing a further £11 to income tax and national insurance, keeping less than a quarter of the £100 payment.

They also have an impact on the fiscal cost of either method. If treated as earnings, the Scottish government (having full control over income tax on earnings) would recoup a small amount of the cost of reversing cuts to the work allowance in extra income tax, but the lion's share of any offsetting cost would be recouped by the UK government in the form of reduced universal credit awards and higher national insurance contributions.

It is also worth reiterating that there are likely to be substantial administrative considerations from either a top-up or discretionary payment. While we do not know the exact division of responsibility in administering different benefit rates between Westminster and the Scottish government, the feasibility of these options will be determined in part by the costs incurred by the Scottish government to implement them.

4.4 Conclusion

On tax, the Scottish government's new powers over income tax offer significant flexibility to reduce or increase tax on earnings paid by Scottish households, particularly those further up the distribution. In fiscal terms, we find that varying either the basic or higher rate of tax can generate a similar fiscal impact to varying the basic rate limit and higher rate threshold. The increase in the UK-wide personal allowance to £12,500, again as planned by the UK government, would see a fall in tax revenues similar to a cut in 1p on the basic rate of income tax by 2020/21.

On benefits, while coverage of devolved disability benefits is low, changes to the level of these benefits can have a significant impact on a claimant's living standards. Increasing them in line with earnings would increase the disposable income of households claiming these benefits by an average of £490 per year at a cost of £100 million per year by 2020/21.

There are also important unanswered questions about how 'topping-up' benefits will operate in practice. If they are treated as income for the purposes of means testing, tax or national insurance, any effort on the part of the Scottish government to reverse upcoming cuts to universal credit will be less effective, since the top-up payments could be in part clawed back by the UK government through higher national insurance contributions or lower universal credit payments. Whether topping-up will be subject to a means test is therefore a key question that must be answered as the Scotland bill makes its way through the UK parliament, and as it is implemented over the coming years..

5. CONCLUSION

Looking ahead to the parliamentary elections in May, we believe the next Scottish parliament is facing the following six key challenges.

- **Challenge 1:** What, if anything, should the Scottish parliament do to reverse UK-wide benefit cuts in Scotland?
- **Challenge 2:** Given UK government plans to increase the higher rate income tax threshold to £50,000, at what level should the higher- and additional-rate thresholds be set for higher earning Scottish taxpayers?
- **Challenge 3:** What should the Scottish parliament do to boost earnings in Scotland, at least in line with UK-wide earnings increases?
- **Challenge 4:** What should the Scottish parliament do to grow the working-age population in Scotland, at least in line with growth in the rest of the UK?
- **Challenge 5:** What, if anything, should the Scottish parliament do to reverse public spending cuts affecting Scotland over the coming years?
- **Challenge 6:** How, if at all, should the Scottish parliament radically reform the income tax system in Scotland over the coming years?

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ANNEX
DATA TABLES

Table A.1
Impact of benefit changes, national living wage, and income tax cuts announced over summer budget and autumn statement 2015 in Scotland, by income decile (average change in household disposable income before housing costs, 2015/16, £ and %)

£ (2015/16 prices)				
Income decile	Benefit changes	Living wage	Income tax	Total
1st (poorest)	-310	20	0	-290
2nd	-590	30	10	-550
3rd	-570	80	10	-470
4th	-450	70	20	-350
5th	-280	120	30	-130
6th	-180	90	40	-50
7th	-80	120	60	90
8th	-40	50	70	80
9th	-20	50	80	110
10th (richest)	0	40	110	140
% change				
Income decile	Benefit changes	Living wage	Income tax	Total
1st (poorest)	-3.20	0.19	0.03	-3.01
2nd	-3.89	0.21	0.05	-3.62
3rd	-3.23	0.43	0.08	-2.66
4th	-2.23	0.33	0.11	-1.77
5th	-1.25	0.53	0.15	-0.56
6th	-0.68	0.33	0.17	-0.18
7th	-0.25	0.37	0.18	0.29
8th	-0.11	0.13	0.18	0.20
9th	-0.05	0.10	0.18	0.23
10th (richest)	0.00	0.05	0.13	0.17

Table A.2

Impact of planned increases in income tax thresholds in Scotland by income decile – personal allowance rising to £12,500 and higher rate threshold to £50,000 (average change in household disposable income before housing costs, 2015/16, £ and %)

£ (2015/16 prices)			
Income decile	Personal allowance	Higher rate threshold	Combined
1st (poorest)	10	0	10
2nd	20	0	20
3rd	40	0	40
4th	60	0	60
5th	80	10	100
6th	120	20	140
7th	150	30	180
8th	190	60	250
9th	220	130	350
10th (richest)	240	350	590

% change			
Income decile	Personal allowance	Higher rate threshold	Combined
1st (poorest)	0.06	0	0.06
2nd	0.12	0	0.12
3rd	0.23	0	0.23
4th	0.28	0.02	0.3
5th	0.37	0.05	0.42
6th	0.44	0.07	0.51
7th	0.48	0.09	0.57
8th	0.49	0.16	0.65
9th	0.47	0.29	0.77
10th (richest)	0.29	0.42	0.71

Table A.3

Impact of changes to rates of income tax on non-savings, non-dividend income in Scotland by income decile (average change in household disposable income before housing costs, 2015/16, £ and %)

£ (2015/16 prices)			
Income decile	Basic rate	Higher rate	SRIT
1st (poorest)	0	0	0
2nd	-10	0	-10
3rd	-20	0	-20
4th	-40	0	-40
5th	-80	0	-80
6th	-120	-10	-120
7th	-180	-10	-190
8th	-250	-30	-280
9th	-340	-70	-410
10th (richest)	-440	-400	-1,050

% change			
Income decile	Basic rate	Higher rate	SRIT
1st (poorest)	-0.02	0	-0.02
2nd	-0.06	0	-0.06
3rd	-0.12	0	-0.12
4th	-0.22	0	-0.22
5th	-0.34	-0.01	-0.36
6th	-0.44	-0.02	-0.46
7th	-0.55	-0.04	-0.58
8th	-0.66	-0.07	-0.73
9th	-0.74	-0.15	-0.88
10th (richest)	-0.53	-0.48	-1.26

Table A.4
Impact of changes to higher rate threshold uprating by income decile (average change in household disposable income before housing costs, 2015/16, £ and %)

£ (2015/16 prices)					
Income decile	CPI HRT	Cash HRT	£50,000 HRT	£48,360 HRT	£45,740 HRT
1st (poorest)	0	0	0	0	0
2nd	0	0	0	0	0
3rd	0	0	0	0	0
4th	0	-10	10	0	0
5th	0	-20	20	10	0
6th	-10	-40	30	10	-10
7th	-10	-70	50	10	-10
8th	-30	-130	110	30	-20
9th	-50	-280	230	70	-50
10th (richest)	-130	-630	600	180	-120

% change					
Income decile	CPI HRT	Cash HRT	£50,000 HRT	£48,360 HRT	£45,740 HRT
1st (poorest)	0	0	0	0	0
2nd	0	0	0	0	0
3rd	0	-0.01	0.01	0	0
4th	-0.01	-0.05	0.04	0.01	-0.01
5th	-0.02	-0.1	0.08	0.03	-0.02
6th	-0.03	-0.14	0.11	0.04	-0.02
7th	-0.04	-0.22	0.16	0.05	-0.04
8th	-0.07	-0.35	0.28	0.08	-0.06
9th	-0.12	-0.61	0.5	0.15	-0.11
10th (richest)	-0.15	-0.76	0.72	0.22	-0.14

Table A.5
Impact of changes to indexation of council tax in Scotland by income decile (average change in household disposable income before housing costs, 2015/16, £ and %)

£ (2015/16 prices)		
Income decile	CPI	AWE
1st (poorest)	-10	-20
2nd	-10	-20
3rd	-20	-40
4th	-30	-50
5th	-40	-70
6th	-50	-100
7th	-60	-110
8th	-80	-150
9th	-90	-170
10th (richest)	-110	-210

% change		
Income decile	CPI	AWE
1st (poorest)	-0.09	-0.16
2nd	-0.07	-0.13
3rd	-0.12	-0.23
4th	-0.13	-0.25
5th	-0.17	-0.32
6th	-0.19	-0.36
7th	-0.18	-0.36
8th	-0.20	-0.38
9th	-0.19	-0.38
10th (richest)	-0.13	-0.25

Table A.6
Impact of changes to benefit rates in Scotland by income decile (average change in household disposable income before housing costs, 2015/16, £ and %)

£ (2015/16 prices)			
Income decile	UC work allowances	Working-age benefit freeze	Increase disability benefits in line with earnings
1st (poorest)	100	180	10
2nd	200	200	10
3rd	220	170	30
4th	210	120	50
5th	150	80	60
6th	80	60	90
7th	30	40	90
8th	20	20	50
9th	10	10	20
10th (richest)	0	0	0

% change			
Income decile	UC work allowances	Working-age benefit freeze	Increase disability benefits in line with earnings
1st (poorest)	1.01	1.90	0.12
2nd	1.34	1.36	0.1
3rd	1.28	0.99	0.15
4th	1.07	0.62	0.24
5th	0.66	0.36	0.27
6th	0.29	0.23	0.33
7th	0.09	0.11	0.28
8th	0.04	0.06	0.14
9th	0.03	0.02	0.05
10th (richest)	0.00	0.00	0.00