THE TAX IMPLICATIONS OF SCOTTISH INDEPENDENCE OR FURTHER DEVOLUTION

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FOREWORD

The vote on Scottish Independence will take place on 18 September 2014. Irrespective of the result, it is likely that Scotland will eventually have more say over its taxes than it currently does, either through independence or some form of further devolution.

ICAS is continuing to contribute to the crucial debate on independence by asking the important questions from its field of expertise and raising the issues that are in the public interest, whilst maintaining an apolitical stance. As part of this programme of work, ICAS commissioned an independent team of academics to undertake a project to consider the tax implications relating to Scottish independence or further devolution. This resultant report takes no view on the desirability of the various options, but rather sets out to help establish the factors that should be taken into account if change is to be achieved successfully. Whilst focusing on Scotland, some of the issues raised in this report would also be relevant to other jurisdictions that are considering some form of devolution of taxes or the establishment of a new tax system.

The original call for research identified the questions that ICAS considered were important to consider in the debate and this research project sought to address these questions by way of a review of existing literature and interviews of 19 individuals. The questions covered issues such as: the suitability of the current tax system to Scotland, practical issues arising in developing and administering a new tax system; the determining factors for designing a new system; the trade-offs and compromises involved; the time required for implementation; implementation issues; risks; educational needs to support a new system; compliance issues; and insights from other countries.

The report suggests that the tax implications of independence or devolution may be more complex than widely thought, and highlights issues that will need to be considered. Many of the issues arising under further devolution or independence will be the same, such as the risks involved and education needs: the difference will be the degree or scale. Other issues identified are specific to independence, such as the design of a new tax system and the status of double taxation agreements.

This project was funded by the Scottish Accountancy Trust for Education and Research (SATER – see page 85). The Research Committee of ICAS has also been pleased to support this project. The Committee recognises that the views expressed do not necessarily represent those of ICAS itself, but hopes that the results of this independent research will contribute to the debate and assist those involved in any future devolution of taxes to Scotland whatever the result of the 'vote' in September 2014.

Allister Wilson
Convener of ICAS Research Committee
May 2014

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Finally, the Research Committee and researchers are grateful for the financial support of The Scottish Accountancy Trust for Education and Research; without this support, the research would not have been possible.

EXECUTIVE SUMMARY

1. This report addresses a series of questions regarding the tax implications of Scottish independence or further devolution on the basis of an extensive interdisciplinary literature review (covering both academic and professional publications) and interviews with 19 individuals who were tax experts or senior civil servants in relevant departments or both. This investigation suggests that the tax implications of independence or further devolution may be more complex than might be widely thought.

2. There is a wide range of tax options available to Scotland under further devolution or independence which would require careful consideration. One possibility is maintaining the status quo (under devolution) or adopting it (under independence) which would have the advantage of using a known system. In comparison, the introduction of different or new taxes (under devolution or independence) or the design of a wholly new tax system (under independence) could be complex. There is, however, a difference between the two scenarios in that with further devolution, reform may be introduced without the pressures that might be involved in tax reform in a newly independent country. It could, for instance, be introduced in stages and at a timing of the Government's choosing. (It should be noted that the words 'new tax system' are themselves often used without specific definition and might carry different meanings, dependent on circumstances. They would always imply, however, one or more substantially new elements.)

3. In the event of independence, the Scottish Government (2013a) has stated that it intends to develop a new tax system for Scotland. However, even with an independent Scotland, such an outcome is uncertain, because a new Scottish Parliament would be elected and a new Scottish Government formed. In practice the outcome might be something between an entirely new system and the current tax system.

4. There is a considerable overlap of the tax implications of the different possibilities involving either independence or further devolution. Some issues, for example, the design of a new tax system of the sort envisaged by the Scottish Government (2013a) and the status of double taxation agreements, would only be relevant in the case of Scottish independence. Other matters, such as those relating to education, risks and practical implications, are broadly similar for either independence or further devolution.

5. In general the evidence suggests the UK tax system works reasonably well in a complex and changing environment, but there is scope for improvement. The Scottish Government (2013a) suggests that "the UK tax system is complex and inefficient" (p. 118) and that it intends to develop a new tax system for Scotland "based on the design principles of a modern and efficient system" (p. 122). This is a laudable aim but there are many reasons why modern tax systems are not closely aligned with such principles in practice and tend to become complex. Devising a new tax system that is workable and acceptable to Scottish taxpayers would involve many serious challenges.

6. There would be numerous practical issues involved in developing and administering a new or supplementary tax system. These include establishing a skilled tax administration in Scotland to replace HM Revenue & Customs (HMRC), ensuring that double taxation and effective information exchange agreements were in place, clarifying the standing of UK case law, agreeing the definition of Scottish resident or taxpayer as well as ensuring an effective IT system including online filing.

7. In deciding whether to base change on the existing system (a 'legacy approach') or to design a new one, the former has the advantage of starting with a functioning tax system which can then be developed over the course of time. However, this approach risks the creation of an overly complex system which lacks coherence and may miss the 'big picture'. On the other hand, whilst developing a new tax system offers the opportunity to create a coherent system, it also risks generating unintended consequences and would raise issues about the acceptance of, and compliance with, the new system. The risks involved in tax reform are likely to be much lower where change is incremental rather than associated with a 'new start'.

8. There are many trade-offs and compromises involved in modern tax design. One example is simplicity versus fairness. A simple tax system has many attractions, but may not take sufficient account of different circumstances to be acceptable to taxpayers. Another example is the trade-offs and compromises required in terms of the policy objectives of taxation versus the levels of taxes set. There may be a fine balance between ensuring sufficient revenue to fund the desired levels of public expenditure and creating a system that does not excessively distort economic behaviour or arouse serious taxpayer resistance. Achieving such a balance can take time and experience.

9. The length of time required to develop and implement new taxes or a new system depends, of course, on the features of the tax or system, the extent to

which it is acceptable to taxpayers and the capacity of the revenue authorities to support such changes. A process of developing a new tax system, including taxpayer consultation, producing a new tax code, recruiting and training tax officials, developing IT systems and preparing taxpayers could take a period of years. Further devolution of existing taxes to Scotland would not require the same level of change and support.

10. The biggest risk associated with a new tax system, such as that described by the Scottish Government (2013a), or any other, is whether it will deliver the desired revenue. Tax compliance is an important issue and the report describes a system of compliance risk management. Another is the international dimension which raises considerations of tax competition and tax harmonisation. A national tax system that deviates significantly from those in other countries may generate economic effects that include undesirable movements of capital and labour. In recognition of the risks involved the report offers a strategic approach to the development tax of policy. There would also be risks involved in the further devolution of taxes but they would not be on the same scale. However, the further devolution of taxation might also benefit from a strategic rather than an ad hoc approach to tax reform.

11. In examining the tax experiences of other 'new' countries or regions, there are few specific lessons that would be immediately applicable without qualification to the tax implications of Scottish independence or further devolution. In particular, the experiences from federal systems, such as those in the USA and Switzerland, are not readily applicable to the situation of an independent Scotland and the rest of the UK (rUK).

12. A new tax system for an independent Scotland or the introduction of new taxes under further devolution would require considerable professional and public education.

13. A new tax system under independence or further devolution of taxes would raise a range of issues relating to tax avoidance.

14. The tax implications relating to the wide range of possibilities associated with Scottish independence or further devolution are far reaching. This report takes no view on the desirability of the various options but rather sets out to help establish the factors that should be taken into account if change is to be successfully achieved. To that end it also offers suggestions regarding successful tax compliance risk management and a strategic approach to the development of tax policy.

1. INTRODUCTION

This report considers the practical implications of further devolution of tax powers in Scotland or an independent tax regime under independence. It addresses specific topics (as set out in Chapter 4) in the context of the following over-arching issues:

- The application of the principles of taxation particularly relating to the efficiency and fairness of taxes and how they may be used to support government policy.
- Ensuring compliance and tackling avoidance and evasion.
- Development and implementation of tax systems (under further devolution or under independence).
- Change management in relation to tax systems.

The report seeks to provide impartial and independent comment on the issues of taxation in Scotland. The authors of the report have no allegiance or links to any parties (political or otherwise) involved in the discussions over the future of Scotland. It is not the purpose of this report to recommend any course of action in respect of further devolution or independence, but to set out the implications and ramifications contingent on both of these options. It should be borne in mind that each of the topics addressed here has been considered only briefly, otherwise this report could have run to several volumes.

2. CONTEXT

Scotland has a unique place in the UK, in that unlike Wales and Northern Ireland, it retained its own hybrid legal system when joining with England to form the UK rather than adopting the common law system used across the rest of the UK (rUK). Whilst Scotland retained its own legal system and many of its own laws, some laws are shared with the rest of the UK, including tax law. This changed following devolution in 1998.

After the vote in favour of devolution, the *Scotland Act 1998* devolved power to the Scottish Parliament to legislate on a wide range of subjects. Several subjects where consistency across the UK was important were reserved to the UK Parliament under Schedule 5 of the Act. These included taxation, with the exception of local taxes to fund local authorities. The Act also provided, in Section 73, power to the Scottish Parliament to vary the basic rate of income tax by 3%. Section 75 of the Act then defined a Scottish taxpayer as someone who is resident in the UK and for whom "Scotland is the part of the United Kingdom with which he has the closest connection". This section was amended by the *Scotland Act 2012* which expanded the definition to specifically include anyone resident in Scotland for income tax purposes or anyone with a close connection to Scotland.[1] Any amounts collected under this power are to be paid to or drawn from the Scottish Consolidated Fund (where there is an increase or a decrease in the tax respectively). To date (March 2014) this power has not been used. After devolution, most taxes in Scotland continued to be collected and administered by HMRC, with the exception of local taxes which are collected by the local authorities. A list of current taxes collected in Scotland is contained in Appendix 1.

In 2008, ten years after devolution, the Commission on Scottish Devolution (the Calman Commission) was established to review the experience of devolution so far. The Calman Commission reported in 2009 and made a number of recommendations in relation to the future of devolution. The Calman Report included a number of recommendations relating to tax and fiscal policy, including that the Scottish Parliament should be able to set the rate of income tax in Scotland, although this would continue to be collected and administered by HMRC. The Calman Commission also recommended that Stamp Duty Land Tax, Aggregates Levy, Landfill Tax and Air Passenger Duty should be devolved to the Scottish Parliament. It further recommended that the Scottish Parliament should be given the power to introduce new taxes in Scotland with the agreement of the UK

Parliament. It recommended that these changes be introduced in an incremental manner to minimise the risks of instability or shocks to the Scottish budget. The Calman Commission also recommended further borrowing powers for Scottish Ministers.

Many of the Calman recommendations were implemented in the *Scotland Act 2012* which further devolved tax powers to the Scottish Parliament, giving it the power to set the Scottish Rate of Income Tax (SRIT), also the taxes on land and buildings transactions and waste disposal to landfill. These changes are expected to take effect in April 2015, at which point the existing Stamp Duty Land Tax (SDLT) and Landfill Tax will not apply in Scotland, being replaced by the Land and Building Transaction Tax (LBTT) and Scottish Landfill Tax respectively. It also provided that the Scottish block grant would be reduced commensurate with the income expected from these taxes. The provisions on the Scottish Rate of Income Tax (SRIT) are expected to take effect on 1 April 2016. Further consultation or legislative proposals on this are yet to take place. However, HMRC and the Scottish Government agreed a *Memorandum of Understanding* on 14 February 2013 on how to address this issue. HMRC has also issued a technical note *Clarifying the Scope of the Scottish Rate of Income Tax* (HMRC, 2012). A separate body established by the Scottish Government, *viz*., Revenue Scotland, will be responsible for collecting LBTT and Landfill Tax.

The *Scotland Act 2012* also provides powers for new taxes to be created in Scotland and for additional taxes to be devolved. The first report of the Fiscal Commission Working Group (2013a, p. 10) set up by the Scottish Government reported that, under present plans, 16% of tax revenues would be devolved to Scotland by 2016.

The constitutional debate has been ongoing in Scotland since before the introduction of devolution. However, since devolution and in particular since the Scottish National Party (SNP) gained a majority in the Scottish Parliament in 2011, the constitutional debate has increased. Various options have been put forward from retaining the *status quo* to full independence. Between these two options there is a wide range of possibilities of further devolution. To many, the concept of further devolution is less clear cut than that of independence, possibly because there are varying degrees of devolution, including the contested concepts of 'devolution max' (devo-max) or 'independence-lite', as shown in Figure 1.

Figure 1 Spectrum of devolution/independence in relation to tax

UK is one state comprising of 4 nations	Varying degrees of devolution											Independence	
	Min			Max									
	Scotland under *Scotland Act 1998*		Current position under *Scotland Act 2012*	Further devolution could include some or all of these or devolution of other currently reserved matters								Independence within a federal UK	Full Scottish independence as a sovereign state
All power held at UK Parliament	Power to create primary legislation in some areas	Power to vary (some) taxes	Power to set (some) taxes	Control over Scottish Parliament and local elections	Control over transport	Control over pensions	Full fiscal autonomy	Control over welfare including benefits / social security	Devolution of all powers except defence and foreign affairs				

Further devolution could range from additional minor powers to just short of full independence. The core discussion on further devolution appears to focus on 'devolution max' as an alternative to full independence. However, Mullen and Tierney (2012) note that there is no single definition of 'devolution max' although various definitions include further devolution of taxation, defence, foreign affairs and social security. In particular, questions arise in relation to what the implications of further devolution would be for taxation. If major changes to the tax system were adopted in Scotland under devolution, there may be wider issues to consider in terms of overall conceptual consistency. For example, if taxation was devolved and Scotland adopted an ideologically different model from rUK, this could cause considerable issues with consistency. Figure 2 shows some possible options in relation to tax in Scotland under further devolution or independence.

Figure 2 Some possible options in relation to tax in Scotland under further devolution or independence

Integral part of UK	Varying degrees of devolution: Min			Max	Independence within a federation	Independence
All power held by UK Parliament therefore tax policy and administration controlled at UK level.	Minimum devolution (under *Scotland Act 1998*) allows Scottish Parliament to add 5p to income tax, no other tax raising or varying powers.	Increased devolution (under *Scotland Act 2012*) transfers power to Scottish Parliament in relation to LBTT tax and Landfill Tax.	Increased devolution – continuum of further devolved powers in relation to tax policy or administration.	Devolution max – could provide for transfer of further or all powers in relation to tax raising and administration or full fiscal autonomy.	Overarching federal government may control some/ all tax policy and administration, and/or national government (Scotland) may control some/ all tax policy and administration (key issue is that there is equality between the federated states).	Scottish Government and Parliament have full control over tax policy and administration as a sovereign, independent state (within the limits of international law).

On 18 September 2014, the voters of Scotland will vote in a referendum to decide 'Should Scotland be an independent country?'. Should the vote be in favour, then work would begin on establishing Scotland as an independent, sovereign state recognised under international law.

The Fiscal Commission Working Group was set up by the Scottish Government to develop a fiscal and macroeconomic framework for an independent Scotland. It has published a number of reports, including one on the macroeconomic

framework (Fiscal Commission Working Group, 2013a), another on fiscal rules (Fiscal Commission Working Group, 2013b) and one on general principles on which the tax system in an independent Scotland might be based (Fiscal Commission Working Group, 2013c). Such principles have been described by various authorities in respect of a number of countries, including the Meade Committee (1978) and the *Mirrlees Review* (Mirrlees, 2010 and 2011) in the UK. These principles are examined further in Chapter 4 below (under question (i)). The Scottish Government's (2013a) proposals regarding Scottish independence stated that the Scottish Government plans "to develop a new tax system for Scotland" (p. 122) would be based on these principles, although the particular issues this would involve were not addressed in detail. However, there were some specific proposals for Scotland, such as linking personal allowances and tax credits to inflation, a reduction in Air Passenger Duty and a competitive corporation tax levied at a rate of "up to three percentage points below the prevailing UK rate" (p. 119). Presumably the UK in this context means England, Wales and Northern Ireland.

The tax system that will be adopted by an independent Scotland is a key issue. Under independence, a new Scottish Parliament would be elected, leading in turn to a new Scottish Government. It would be for this government to decide on the tax system to be used. It is possible that it would choose to retain the current UK system, but it is also possible that it would choose to redesign the system from scratch or select any option in between. This report considers the options which might be available.

3. METHODOLOGY

The report is based on two elements:

(i) an extensive, interdisciplinary desk-based literature review (covering both academic and professional literature); and

(ii) a series of interviews with the following, listed in alphabetical order of surname:

- Alistair Brown, Fiscal Responsibility Division, Finance Directorate, Scottish Government
- Iain Campbell, Enforcement and Compliance, Organised Crime Policy and Planning Unit, HMRC Scotland
- Michael Clancy, Director of Law Reform, The Law Society of Scotland
- Stephen Coleclough, President, Chartered Institute of Taxation
- Alison Cumming, Fiscal Responsibility Division, Finance Directorate, Scottish Government
- Paul Dempsey, Assistant Secretary, Corporate Services Division, Irish Revenue Commissioners
- Eleanor Emberson, Head of Revenue Scotland and Director of Financial Strategy, Scottish Government
- Nicky Harrison, Chief Operating Officer, Revenue Scotland
- Karen Henderson, Senior Lecturer in Politics and International Relations, University of Leicester
- Peter Hobbs, Former Head of Tax, BP
- Brian Keegan, Director of Taxation, Chartered Accountants Ireland
- Lisa Lane, Thomas Westcott, Chartered Accountants
- Jeffrey Owens, Professor, Institute for Austrian and International Tax Law, Vienna University of Economics and Business, former Head of OECD Centre for Tax Policy and Administration
- Tina Riches, then Technical Director, Chartered Institute of Taxation
- Dale Simpson, Chairman, South West of England Branch, Chartered Institute of Taxation
- Patrick Stevens, Immediate Past President and (current) Tax Policy Director, Chartered Institute of Taxation
- Doug Stoneham, HMRC, London
- Chris Wales, PwC, Tax Adviser
- John Whiting, Tax Director, Office of Tax Simplification

In the report which follows, interviewees are referred to anonymously by a number, which does not reflect their position in the above list. Most interviews were recorded, with interviewees' permission, and then transcribed verbatim. The verbatim transcripts were then reviewed by the interviewees for accuracy and clarity, with some minor amendments being made. For interviews that were not recorded, detailed notes were made by the interviewer.

The open-ended, semi-structured interviews used questions which were based on the ten research questions, as specifically set out in the original ICAS invitation for research proposals, together with one other question (question (i)), as detailed in Chapter 4. The interview structure thus provided *a priori* for the themes along which the interviews were subsequently analysed, using typical content analysis (see Taylor and Bogdan, 1984; Lincoln and Guba, 1985). The transcripts of the interviews were read and re-read in order to develop a full understanding of the responses.

Both the literature review and interviews addressed the 11 topics and are integrated in the discussions in Chapter 4.

4. RESEARCH FINDINGS

In the context of the over-arching issues outlined in Chapter 1, the following ten questions, as specifically set out in the original ICAS invitation for research proposals, together with one other question (question (i)) are addressed. However, there is inevitably considerable overlap between some of the areas covered, and some topics might reasonably be addressed in response to several questions.

(i) Is the current UK tax system fit for purpose for modern Scotland?

The starting point for this report was that at the date of writing (March 2014), Scotland, despite differences in other laws, remained largely subject to the same tax system as the rest of the UK. This raised the question of whether the current system was fit for purpose in Scotland, i.e. did it effectively and efficiently collect taxes in keeping with accepted tax principles such as fairness, etc. In terms of full fiscal independence in an independent Scotland or further devolution,[2] the problem would be, to varying degrees, whether to retain whole or part of the existing UK system, or none of it, and, depending on the choice made, which elements to retain or devise anew. If a consensus were found, for example, that the current system did not work – or did not work in Scotland – then there would be no point in considering any substantial retention for the longer term of what already exists.

Aitken (2010, p 14) queries why it might be assumed that Scotland would "simply copy the present UK tax system". Indeed, as indicated above, the Scottish Government (2013a) has now proposed to develop a new tax system for Scotland. However, Aitken acknowledges and recommends that:

> *As a starting point… if a tax were to be properly devolved, the UK legislation should be copied en masse. That would ensure a period of certainty, which is very important when such a major change is being undertaken.*

Most of the interviewees expressed a similar view, that is, that the system works, but is not perfect.

> *Yes, it is fit for purpose, because when all is said and done… , we are raising half a trillion pounds or whatever it is, it's coming in reasonably efficiently… But – and you would expect the 'but' to*

come – there are some creaks and cracks… (Interviewee 10)
The statistics show that 90% of their [UK's] *revenues come in without anybody having to do anything. And 3% come in with a bit of prodding, and then the 7% is the gap where the Revenue have to chase it. So, on those numbers, and those are the best in the western world, the system's fine. There are problems with the tax system though: it's not perfect by a long way.* (Interviewee 12)

I think the easiest place from which to start is always a pre-existing system that functions, that delivers revenue, [but] *there are a lot of things in the UK tax code that I wouldn't want to have in my personal ideal tax code.* (Interviewee 14)

However:

The Calman Commission evidence suggested the devolution of some taxes and this possibly indicates that not everyone is content with how the UK tax system applies in Scotland… (Interviewee 11)

Interviewee 15, however, felt that the current UK system was not very efficient in terms of the amount it cost to collect, so that cast some doubt over the fitness of purpose of the current system.

Interviewees did feel, however, that any system changes would present opportunities for improvement and elimination of particular elements that do not work well (e.g. inheritance tax), and "nuancing" (Interviewee 9) to account for Scotland's different legal system. This is perhaps summarised best by Interviewee 14:

But would a UK-style tax system suit Scotland? Well, it's obviously worked, to some extent, today, so I would certainly think it was worthwhile taking most of it and just developing and adapting it, some of it perhaps a little bit during the transition, but more of it as time went on.

It is worth noting that many of the points highlighted above might be addressed by the UK Parliament within the current constitutional set-up, by the Scottish Parliament if further devolution over taxation were granted, or by the Scottish Parliament under independence. The only substantial point which applies solely to

independence is that of creating an entirely new system, as it likely that the power to make such change would only be available to a sovereign, independent state.

Many theorists have expended a great deal of thought and ink in considering what should be the underlying ideals and principles on which a tax system (and taxes generally) should be founded. Still relevant are the concepts (or canons) of equity/proportionality, certainty, convenience and efficiency propounded by Adam Smith in Book 5 of his work, *An Inquiry into the Nature and Causes of the Wealth of Nations*,[3] to which later theorists have added neutrality, correction/control/influencing of behaviour, flexibility, simplicity, fairness accountability and acceptability (in terms of behaviour of governments and individuals) (see Daunton, 2001). The *Mirrlees Review* of the UK tax system (Mirrlees, 2011, p. 22) accepted Smith's canons as commanding "near-universal support but they are not comprehensive, and they do not help with the really difficult questions which arise when one objective is traded off against another". The *Review* (pp. 22–23) goes on to say:

> *The way we formulate the objectives of a tax system is to say that for a given distributional outcome, what matters are:*
>
> - *the negative effects of the tax system on welfare and economic efficiency – they should be minimized;*
> - *administration and compliance costs – all things equal, a system that costs less to operate is preferable;*
> - *fairness other than in the distributional sense – for example, fairness of procedure, avoidance of discrimination, and fairness with respect to legitimate expectations;*
> - *transparency – a tax system that people can understand is preferable to one that taxes by 'stealth'.*
>
> *Simple, neutral, and stable tax systems are more likely to achieve these outcomes than are complex, non-neutral, and frequently changing systems. But simplicity, neutrality, and stability are desirable because they promote these ultimate outcomes, not in their own right.*

However, "[i]t is generally acknowledged that the UK has one of the most complicated tax systems in the world" (Aitken, 2010, p. 14), rendered more complex because many elements cannot be divorced from their underlying history and/or connections to other elements. If one were designing it from first principles, one

would not start from where we are currently. William E. Simon, a former Secretary of the US Treasury, succinctly summarised this when he said that a "nation should have a tax system that looks like someone designed it on purpose" (US Treasury, 1977). Most nations do not. Undoubtedly, the UK tax system does not have the appearance of a coherent design. The *Mirrlees Review* (2011, pp. 478–479) sets out the problems characterising the current UK tax system – "[a] jumble of tax rates, a lack of coherent vision of the tax base, and arbitrary discriminations across different types of economic activities". It also (*ibid.*) sets out what a "good tax system" would look like. The 2013 Institute for Fiscal Studies report on *Taxing an Independent Scotland* (Adam *et al.*, 2013) is heavily influenced by the *Mirrlees Review*. How far such a "good tax system" could, or even should, be implemented in its pure form after taking account of the many considerations involved in the operation of a tax system in practice is very relevant in the present context.

Tax simplicity is an area of tax policy where a wide context and trade-offs between inter-related factors need to be taken into account. Often the trade-off is between simplicity and horizontal and vertical equity, that is, a complex tax system can take better account of the different situations in which taxpayers may find themselves. A good example is provided by the UK's Community Charge of 1989–90 (tried out first in Scotland), which was a well thought out tax, except in one crucial aspect: as a flat-rate tax it was felt to distinguish insufficiently well between individuals' ability to pay, so violated equity – and with disastrous results (Smith, 1991; Cullis *et al.*, 1993; James, 2012a, pp. 56–57; James, 2012b, pp. 471–472).[4] This was unlike the introduction of Value Added Tax (VAT) in 1973, which met with widespread acceptance (James, 2012b). Also a more complex tax system can better differentiate between government policies, such as supporting certain activities and discouraging others. However, often the idea of tax simplicity is considered only in the context of simplification of tax law. The UK Tax Law Rewrite Project was established to redraft tax legislation "to make it clearer and easier to use, without changing the law" (*Tax Law Rewrite*, on HMRC's website). Rewriting law is never easy, as is evident from the Tax Law Rewrite, which indicates that a number of statutory instruments has had to be put into place to implement "missed consequential amendments and errors". Time to identify corrections has even been included as part of various Acts. The rewrite of UK tax law has undoubtedly resulted in a more voluminous body of legislation.

Complexity in tax law results from three things – language, policy and compliance – all of which would need to be addressed if tax is to be reformed (Tax Law Review Committee, Final Report, 1996, paragraph 6.10): it is not merely a linguistic problem,

as is often assumed and which was specifically revealed by a recent rewrite of Australian income tax law. Despite the rewrite producing legislation that was easier to read and understand, complexity remained as a result of its "wholly irrational and inconsistent policy base" (Krever, 2003, p. 493). More recent work (the Taylor Report, 2006,[5] cited by James and Edwards, 2008, p. 44) commented that Australian tax law is still rendered complex by its "excessively detailed operational rules". Acknowledgement that a broader approach is needed to tax simplification is commented on widely by researchers, for example, Owens and Hamilton (2004) and McKerchar *et al*. (2007), who compared the simplification process experiences of the USA, UK, Australia and New Zealand. All concur that a clear tax policy is a main component of making tax law simpler. The lessons from recent rewrite projects are self-evident for any rewrite of or new drafting of tax legislation for Scotland as part of further devolution or independence.

The *Mirrlees Review* comments further (p. 35) that optimal tax theory (discussed later, under questions (iii) and (iv)) considers how different tax objectives are traded off against one another. It is at least arguable that much of the current complexity of UK tax law is caused by a trade-off between different 'ideal' characteristics. For example, a complex tax may be perceived as fairer than a simpler one – and fairness is of great importance, as the example of the Community Charge shows.

The nature of an ideal tax has been the focus of much debate in recent years, and not all thinkers would necessarily agree with the characteristics listed above. In 2001, the American Institute of Certified Public Accountants (AICPA) produced a document suggesting ten guiding principles for good taxes, which includes some of the above, but not all. A 1999 discussion document entitled *Towards a Better Tax System*, published by the Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW), analyses the problems in the UK taxation system. The system is "far too complex", "full of anomalies", "caught in a culture of never-ending change" and is "lacking in democratic control" (p. 3). The Tax Faculty document (pp. 4–5) suggests ten tenets for a better tax system, namely that taxes should be statutory (that is, enacted by primary, and not delegated, legislation), certain, simple, easy to collect and calculate, properly targeted, constant, subject to proper consultation, regularly reviewed, fair and reasonable, and competitive.

Richard Murphy, in his 2007 *A Code of Conduct for Taxation*, goes beyond this in his development of a voluntary code of behaviour based on the United Nations' *Universal Declaration of Human Rights* (although the latter itself makes no reference to taxation). He develops this with the aim of addressing "organised tax

avoidance" (p. 2) on a global scale and deems Adam Smith's maxims "outmoded" (p. 8), because they (p. 9):

> *...fail to recognise the obligation of the State to the citizen with regard to the provision of public goods, and relate primarily to the practice of taxation rather than the principles that underpin it.*

Society now is very different from that of Smith's time. On pp. 9–10, Murphy sets out a series of principles, namely that the State should: protect its citizens; provide public goods; not discriminate in protection/provision; democratically determine its provision; be unconstrained by the action of another state; and levy taxation, which must respect the right to hold private property; must be imposed by law; must not be arbitrary; and must apply to all citizens. Citizens must pay the tax due by them, but can appeal against it, although they must disclose all relevant data to the State. They do have the right to leave, in which case they lose their right to State protection and provision, but equally are not obliged to contribute to its maintenance.

If Scotland were to follow the route of independence or further devolution, it could be faced with the possibility of introducing a set of new taxes, which would require legitimation by the Scottish Parliament and acceptance by taxpayers. Care needs to be taken when introducing any new tax. As the UK experience of the Community Charge shows, it is very easy for the introduction of a new tax, however clearly heralded, to fail. As Smith (1991, p. 435) concludes, it was "a salutary lesson in the importance of designing tax schemes that enjoy widespread acceptance".

(ii) What practical issues arise in developing and administering a new or supplementary tax system, what capacities are key, and how might capacity requirements be met?

There are innumerable practical issues which would have to be considered for a new or supplementary tax system from the standpoint of tax policy and administration.[6] Per Interviewee 5:

> *Thinking in broad terms about the capacity needed to deliver the taxes under the Scotland Act 2012, they broadly break down into policy capacity and administrative capacity. Both will be needed, at a relatively small scale, in respect of the two devolved taxes. The policy capacity will have elements of finance, economics and the law in it. An understanding of how taxes operate when applied to*

> *specific economic activity such as land transactions will be needed. This capacity is being developed.... The key to administrative capacity is having staff who are trained, supported by effective IT systems. Existing sources of expertise have already been tapped into, through recruitment and secondment.*

This was echoed by Interviewee 6:

> *To be honest, the first set of issues are about tax policy and the design of the taxes. Before you even think about how you would administer them, ... but everyone's aware that what you choose to tax, and how you choose to tax it, are the things that are going to start you off, and they're the fundamentals, and then you have to build an administrative system ...to meet the desired policy objective, but if you're careful in the way you specify your policy objectives, then you can make the administrative part much easier.*

Currently, the vast majority of tax administration is done by HMRC for the whole of the UK, though some responsibility has been devolved to Revenue Scotland. However, while HMRC has offices in Scotland, all staff across the UK deal with queries on a UK-wide basis, not just for the location in which they are based. There is a fairly wide public perception that, because HMRC has offices in Scotland, those offices could just transfer to being part of a Scottish tax administration under independence. The situation is not as clear cut as this.

Under further devolution, it might be envisaged that greater responsibility over time would be devolved to Revenue Scotland. However, a decision would need to be taken as to whether or not HMRC or Revenue Scotland would administer further devolved tax(es). It was a deliberate choice by the Scottish Government to set up Revenue Scotland to administer LBTT and Landfill Tax, as it could have asked HMRC to do this.

> *I must admit that, political considerations apart, if I had been deciding whether or not to set up Revenue Scotland north of the border or use HMRC on a sub-contract basis, I would have been sorely tempted to use HMRC on a sub-contract basis. The whole infrastructure that goes with setting up a revenue agency, I think is a complete nightmare.* (Interviewee 14)

The challenges under fiscal (and political) independence would be much greater. An independent Scotland would need to have in place an administrative infrastructure at national and international level able to deal with tax returns of all kinds, queries of all kinds and tax collection, which would involve ensuring continuity between existing systems and any new system or 'add-ons' and adequate staffing and training, and would require a considerable amount of resources to establish.

> *The task of envisaging and consulting on new taxation systems and then legislating for, developing, testing and implementing them is significant. It's an obvious thing to say, but in practical terms it would be very difficult to do that for a wide range of taxes all at once. But it's perfectly credible to think of reviewing taxes one group at a time to consider how they might be further developed.* (Interviewee 5)

> [Y]*ou do have the obvious issues of the whole staffing and expertise and organisation of it. Revenue Scotland is still, I think, in single figures in terms of people and they're aiming to get to between 20 and 30 people. Now, that's fine for running a couple of taxes and negotiating with the Revenue about running a Scottish Rate of Income Tax. Going from there to setting up a 1,000 person tax authority or perhaps 2,000, that's a different issue! This would be a major exercise and whether they just bid to take over Cumbernauld and Glasgow, I don't know, but… there's a huge issue there and what can be done with taking on two or three little taxes is fine, but then suddenly leaping, as it were, to going and collecting income tax or national insurance, or whatever…* (Interviewee 10)

> [They need] *a collection agency with knowledge and experience…* [otherwise] *it couldn't do the job. That's the kind of problem that they're going to have.* (Interviewee 10)

It is currently felt by some, for example, that HMRC's centralisation of services with the closure of local offices has resulted in local knowledge being lost (Interviewee 9). This is set to continue with the recent announcement of the establishment of a digital office in Newcastle "to force taxpayers to use online services by default and eliminate paperwork" (AccountancyLive Update, 2014), which will replace a number of local offices. The capacity requirements under devolution and independence

might thus be very different, but this will depend on the extent of devolution and the choices made as to who might administer additional devolved tax(es) under that option.

A fully independent Scotland would also mean that a land border would be created between England and Scotland in a way that currently does not exist. A consequence of this might be a need for Scotland to re-negotiate information exchange agreements and double tax treaties:

> *Probably the main* [key capacity] *is international relations, if you like. You know, the UK has 110 tax treaties, however many we've got; we're a member of the EU, so all the EU arrangements. Does Scotland just inherit that? Presumably not automatically.* (Interviewee 10)

Interviewees 1 and 19 expressed similar concerns. Interviewee 8 commented that there would be no inward investment into Scotland unless there were double taxation agreements in place, which "would be a huge challenge for a new administration". The view of most experts interviewed was that Scotland could not automatically assume that existing treaties and arrangements made with the UK would apply. However, others have argued that an independent Scotland would inherit all existing treaties. This is a legal issue, where absolute clarity would need to be obtained, as a failure to have such international agreements in place could be very damaging, especially to business. The Scottish Government has made clear in its White Paper (Scottish Government, 2013a, p. 387) that it intends "to adhere to all international tax treaties in force between the UK and third party states, so that these treaties can continue in force between Scotland and that state", but the legal situation is unclear here.[7] A similar issue arises in regard to the standing of UK tax case law and precedent, and where any tax case might be pursued.[8] Many VAT offences, for example, are assumed to be committed in Southend-on-Sea, as the VAT head office is located there. There might also be issues about the country-identifier for VAT invoices.

A key practical issue under independence would be defining who is a Scottish taxpayer in terms of individuals and companies. This is currently defined in the *Scotland Act 2012* for individuals, for the purposes of the Scottish Rate of Income Tax, by the main place of residence or a close connection to Scotland. This may cause dissension among Scotland-born individuals who are non-resident – as well as among non-Scotland-born individuals who do live in Scotland.

> *There's a lot of Scots south of the border who wouldn't be pleased with that… and there'd be double tax issues, and what about the Scot who, you know, commutes from the Republic of Scotland… you know, all those cross border worker issues that you see in the tax cases in the European court…* (Interviewee 12)

Adam *et al*. (2013, p. 26) suggest that this would create additional compliance costs for taxpayers as they would need to work out where they should pay tax.

There are other more specific issues which must also be considered in any future tax system in Scotland. For any system based on electronic filing, the issue of reliable access to the internet is key. With 76% of Scottish homes having access to the internet (lower than that UK average of 80%) (Ofcom 2013), not everybody is able to or will be able to access electronic filing. This does not account for those households which have internet access but do not feel competent or comfortable to file their tax returns online. This is an issue which affects any tax system, including the current tax system operating in Scotland as well as any future devolved or independent system, and the rest of the UK. It is also worth noting that HMRC's issues with its current IT system have been well documented therefore having an effective and efficient IT system and support services are essential. Under independence a decision would need to be made as to whether to create a new IT and online filing system specifically designed to meet the needs of whatever tax system was to be established, or to adopt or buy-in the current HMRC system.

(iii) What are the determining factors for a 'new' country designing a tax system? For example, should there be a legacy approach, a new start, with a simpler approach or an approach to fulfil other political or economic objectives?

(iv) What trade-offs or compromises arise and on what basis?

The above questions are addressed together. The reason for this is that there is considerable overlap between them – and also between certain practical issues, as a practical issue may well turn out to be a determining factor. In terms of whether a 'big bang' approach (introducing a new system all at once) or a more transitional approach to tax reform is appropriate, the literature is divided, and it is clear that there are trade-offs here too. For example, Goode (1984) suggests that incremental change risks missing the 'big picture' but is less resource intensive so has more chance of success. Gillis (1989) argues that it is unclear whether a 'big bang' or

incremental approach is better, whilst Sandford (1993) argues that a 'big bang' approach is appropriate as an incremental approach risks losing focus.

Something that might appear to be a sound idea – a sensible tax policy, for example – may be prevented from being implemented because of practical considerations and thus lead to a compromise or trade-off. As Interviewee 14 commented:

> *I've just been advising the… Finance Minister in* [Eastern European country] *about whether or not he should have disclosure provisions, and I said, 'One of the problems is that you don't really have the resources at the moment to make your existing tax system effective. So if you add on all these complications and you don't already have proper anti-avoidance legislation…'*

The formulation of tax policy is complex, as it is linked to the wider context of the changing legal, social and political environment, government expenditure programmes and economic and non-economic variables, which might have administrative or other practical implications. Wales and Wales (2012), in their report on *Structures, Processes and Governance in Tax Policy-Making: An Initial Report*, conclude (p. 7) that, in all countries considered, "the importance of tax policy-making is undervalued; and, largely as a consequence, it is under-resourced – particularly compared with other functions of government". Any government must make decisions about the public services it will provide and the taxes it will levy to fund them. Under devolution, different policies between Scotland and rUK (e.g. provision of free higher education for Scottish students, free care for the elderly, etc.) may have, depending on the nature and extent of provision from public revenues, considerable implications, not least in terms of public perception of those policies. Under independence, this might not be the case, but other issues would arise, such as (Scottish rights to) the actual and potential revenue from further exploitation of wave power or North Sea oil and gas reserves (see Adam *et al*., 2013, pp. 36–37), and in due course, the costs of decommissioning oil platforms.

> *The Scottish administration is going to have to decide what kind of social services and infrastructure it's going to provide, how much that's going to cost, and how they're going to fund it. So if the Scottish social policy demands tax collection of X, the tax system is going to have to be able to yield X or a percentage of X in order to make that work.* (Interviewee 9)

> *It may well be that the Scottish Parliament might decide that they're going to have a relatively slim level of social service, and therefore a relatively slim tax system. And I'm not suggesting that Scotland would become a tax haven, but that it might be very advantageous for multinationals to establish themselves.* (Interviewee 9)

> *I was reading somewhere the other day that their expenditure per head is significantly more than the revenue per head compared to the rest of the UK. I must admit that I have seen conflicting figures, so I'm not sure which are the most accurate ones, but I mean, if that is the case then that's going to present Scotland with a huge issue if they become fully devolved, completely independent, as to how they fund that. Because they've either got to borrow more, which may be difficult, spend less, which may be politically difficult, or raise taxes, and none of them are easy options.* (Interviewee 16)

Often the wider context and the interplay between competing factors are not adequately considered, with the result that too narrow an approach to tax policy is adopted (see James and Edwards, 2008, pp. 35–37), and then subsequent 'work arounds' are implemented. Wales and Wales (2012, p. 7) also comment on another aspect of narrowness, namely that "tax policy is made and influenced by a very small group of people. There are too many outs and too few ins for an issue that affects so many people. The narrowness of the process has the potential to create unbalanced outcomes in the absence of other safeguards".

While there is a considerable body of research on tax policy making and tax reform, two dominant themes emerge, regardless of the lens through which they are viewed, one being unintended adverse consequences and the second being trade-offs (though the two may be combined). The various perspectives are considered below.

James and Edwards (2008, p. 37), when considering the contributions made by economic analysis to tax policy, for instance, point out under the 'general theory of the second best'[9] that:

> *The variables in an economic system interact so that changing one part will have effects on other variables that are not even*

> *directly involved in the initial change. A limited analysis may fail to anticipate such changes, which could offset the original intended improvement. This can mean that a reform designed to achieve an economic improvement, far from actually doing so, might even make things worse.*

For example, suppose a tax is imposed on a manufacturing process, which creates a lot of harmful pollutants, but where the end product itself, a medicine, is widely prescribed by doctors because it is the most effective treatment for numerous common medical conditions. The tax would increase the overall price of the medicine, with the likely effect that its use would decrease, people would be prescribed less effective medicines and need more time away from work to recover, with adverse effects on the economy in terms of lost production, which might outweigh the effects of the tax collected on the manufacturing process. There are obvious implications here for any government amending an existing tax system or setting one up *de novo*, in that it must consider the potential unintended consequences of any policies as well as those intended. Economic analysis also incorporates a wide body of work on optimal taxation. Optimal taxation is concerned basically with economic efficiency and equity/fairness. Tax structures, policies, systems and taxes themselves should be arranged to take account not only of economic efficiency but also fairness to taxpayers. Given that something that is economically efficient need not be fair – and *vice versa* – there is a balance to be struck here, hence a trade-off between the two concepts. The instance of the Community Charge referred to earlier shows an effect of an unworkable balance being struck, which affected both Scotland as well as the rest of the UK. As Interviewee 5 commented:

> [T]*here are trade-offs in tax policy terms between, for example, simplicity and fairness. Everybody wants a simple tax system but they also want a fair one. To give an example of a trade-off, a simple tax system might not include any reliefs or allowances. But many people would think that it wasn't very fair to tax the first dollar you earn. For people on low incomes, there would be a perfectly fair view that they ought to keep all of their first dollar. So simplicity and fairness have to be balanced. There would have to be similar trade-offs between simplicity and the perceived attractiveness of a tax system to the company sector, for example, in giving allowances for investment expenditure.*

James and Edwards (2008, pp. 38–39) provide a useful summary of the issues examined by the body of work on optimal taxation:

- uniform commodity taxes rarely being optimal (Ramsey, 1927);
- optimal taxation being introduced only if acceptable within the political-economic process (Frey, 1976);
- too much emphasis being placed on optimality at the expense of the process of achieving it (Feldstein, 1976);
- the question of whether optimal taxation can make a practical contribution to tax policy, as raised by Heady (1993) and echoed by Alm (1996), who suggested that issues concerning fiscal and social institutions are ignored and that it is impossible to consider all the complexity associated with tax systems;
- political mechanisms that ensure restraints on taxation which enhance efficiency (Gradstein, 1999);
- the marginal tax rate being lower in the presence of tax evasion (Cremer and Gahvari, 1994 – though this is dependent on the assumptions they make); and
- the fact that 'sin taxes' on unhealthy items, involving a return of the proceeds to taxpayers, can increase economic welfare (O'Donoghue and Rabin, 2006 – though this conclusion could be reached without reference to optimal taxation, and the authors do recognise the limitations of their particular analysis).

With existing tax systems, trade-offs between different considerations have developed in the light of experience over long periods. This leads to considerable modification of the systems to accommodate a wide variety of pressures in order to achieve a workable balance between those competing interests (see, for example, James, 1999; James and Edwards, 2008). This is the challenge which Scotland will face if designing a new tax system under independence. Whilst the Scottish Government's (2013a, p. 122) proposal is for a new tax system based on the "design principles of a modern and efficient system set out by the Fiscal Commission", any system will also have to make trade-offs to take account of competing interests.

(v) How long would it take to implement a new tax system and what would happen in any transitional period?

Under further devolution it is possible that further taxes might be devolved, or under 'devolution max' that all taxes might be devolved. However it is unclear

whether this would provide scope to design a wholly new tax system, particularly as it would be constrained by existing UK tax treaties and the need to co-ordinate with UK tax policy to varying extent. This need would not exist under independence as an independent state would be free to implement any tax system required to pursue its own objectives, provided that this accorded with any tax treaties to which it were party.

The question of how long it would take to implement a new tax system depends on what is conceptualised as a new system. The introduction of individual new taxes can take a few years (as in the case of VAT, the Community Charge, and more recently LBTT and Scottish Landfill Tax), as can the change of administration (for example, the merger of the UK Inland Revenue and HM Customs & Excise in 2005 to form HMRC). The introduction of a wholly new tax system incorporating new tax policy and administration would also depend on several criteria, namely:

- the precise nature of the system and how wide-ranging it might be;
- whether it was accepted by those being taxed; and
- the level of support provided by any current tax administration.

In relation to Scotland, these criteria might be similar regardless of whether further devolution or independence were under consideration.

The advantages of keeping as much as possible from the existing UK system (a legacy approach) would be its familiarity; people would know how it worked. New elements might be introduced subsequently, on a phased implementation basis over a specified time period. For example, in Ireland, in 1922, on the creation of a separate state, there was a 'lift and drop' of existing UK tax legislation, supported by the presence of UK Revenue Commissioners for some 12 months (Réamonn, 1981), which provided a basis from which to develop further Irish legislation. The Board of Revenue Commissioners for Ireland, when set up, followed the UK pattern (Réamonn, 1981, p. 41). This model seems to have been effective, despite a history of prior violent conflict, during which tax records were burned in an attempt to cripple public administration (Réamonn, 1981, p. 39). However, a 'lift and drop' approach might also bring its own problems:

> *Equally, you have to recognise that for a period of transition, just replicating what is there already is often the easiest if not the best. But there is the danger that if you 'copy-and-drop', then you get stuck with something for a long time because nobody wants the*

> *political pain of making the change once you have a functioning tax system in a country. And, I mean, that's one of the things that's certainly bedevilled tax reform for a number of countries, including, particularly, the UK.* (Interviewee 14)

Some states have begun with a 'big bang' approach,[10] such as Israel in 1948, with a tax system being enthusiastically welcomed. Likhovsky (2007, p. 672) cites (from Cohen, 1958, p. 5 and p. 9) the recollection of a tax official, during the first months after independence, that there was a willingness to pay higher taxes than would have been paid to the British Mandate and the argument between two well-known citizens of Haifa as to who was the first to pay income tax to the provisional government. Although compliance with British taxation was low, the Palestine Jewish community had:

> *...established a system of autonomous voluntary taxes designed to finance Jewish military expenditures in the face of growing and often violent Arab opposition to Jewish presence in Palestine. At first, these taxes were paid on a local basis, but in 1938, during the Arab rebellion of 1936–1939, a national organization was established, and progressive income and property taxes, as well as indirect taxes (collectively known as Kofer ha-Yishuv), were levied on the Jewish community.* (Likhovsky, 2007, p. 671).

There was thus a tradition of paying taxes in support of the state.

However, the increased complexity of tax systems makes a 'big bang' approach impractical. Substantial prior pilot testing/parallel running would be required if this were envisaged.

> *If it's anything other than tax, you'd say it would be a really good idea to have a brand new start and have everything shiny and polished and ready to go on the first day and just introduce it, but, unfortunately, the world of tax is a bit different, and so, generally speaking, the last thing anybody wants is a new tax. If I was recommending to a minister what to do, I would say, 'Stick as closely as you can to the UK model so that you should get the easiest possible transition'.*
>
> *I would think that relying on a legacy system was probably the best answer, at least for a transition period.* (Interviewee 14)

An incremental approach might be adopted, that is, adoption of the legacy system to start with and then implementation of changes as required or desired, thus allowing time for testing, public acceptance, etc. It should also be borne in mind that creating effective tax code is a time-consuming process, so if there were a decision to create entirely new law, then this might take many years.

> *If you're going to start writing a new tax code, the practicalities, I would suggest, are enormous. It would be untried, and the idea of starting to write law from nothing for covering a whole tax code – and just bear in mind the size of the UK tax code – I think that would keep you going until the 22nd century.* (Interviewee 17)

In terms of a transition period for Scotland, there would be considerable reliance on HMRC as part of the process and afterwards, both under devolution and independence.

> *I think the whole thing* [establishment of tax offices, appointment of revenue officials, and any sort of transition or handover] *will be very problematic.* (Interviewee 14)

> *I could envisage that Scotland would need the support of HMRC in some way, whether it's as a collection arm or whether it's for advice or whatever. I would imagine that won't drop away for many years.* (Interviewee 16)

Interviewee 16 also pointed out that the Falkland Islands, a British Overseas Territory with its own tax authority, is still supported by HMRC, with reference currently to its expertise in petroleum taxes, given ongoing developments there.

Interviewee 5 summarised the challenges succinctly:

> *They would certainly need a lead-in time. And, thinking about the importance of consulting the public and taking them with you, there would be a significant process of initial policy development followed by consultation and engagement, followed by further policy consideration and legislative drafting …certainly, in an ideal world* [you would want] *to consult at each stage of that process. And then there is Parliamentary scrutiny and passage of the legislation. Then you need to sort out the administration,*

including recruiting and training staff and building IT systems and testing them. Another very important factor is making sure that employers' or tax agents' systems can interact successfully with the tax authority's systems. And all of that takes time.

Thus whether further devolution of taxes or developing a new tax system under independence is envisaged, a substantial period of time will be needed and serious consideration should be given to the best approach to introducing any changes.

(vi) What are the most significant implementation issues?

(vii) What are the key risks and what can be done to mitigate those risks?

The above two questions are addressed together as they are closely interconnected. In terms of any new or supplementary tax system, the key issue must be whether that system will deliver the desired revenue.

> *The key objective for a newly independent Scotland would be securing revenues due to it. And anything that seriously risked that would have to be avoided because of the profound consequences if revenue due was not gathered in. So, that would be a factor to be taken into account.* (Interviewee 5)

> *The obvious biggest risk is – will they get the money that they anticipate?... That, to me, is the main risk... the other risks are clearly overburdening the tax authority, not communicating properly to the taxpayers, taxpayers being left confused and not knowing what to do. And, of course, in this day and age... that opens up, possibly, avoidance and evasion, which... remains... a huge risk.*

> *In this day and age, I'm a firm believer, compared with 19th and 20th century taxes, the population basically has to accept the tax and buy into it and that means communication, explanation, making sure that people realise it's value for money, etc., etc. You can't anymore just impose them – well, it's a huge risk if you do.* (Interviewee 10)

In many respects, this all boils down to the issue of getting the tax rates 'right' so as to raise sufficient revenue and getting taxpayers to pay taxes deemed due – in

other words, tax compliance. Scottish independence or further devolution raises the possibility of a different approach to tax compliance. In international financial management there is the phenomenon of 'regulatory arbitrage' whereby, in a global economy, financial institutions route financial transactions around jurisdictions to utilise regulatory regimes to their advantage – and this could include tax regulation.

However, without seriously running such risks, it is possible for Scotland to change the emphasis of tax compliance policy. There is a voluminous literature on tax compliance see, for example, Ahmed *et al*. (2003), Evans (2003), Fischer *et al*. (1992), Jackson and Milliron (1986), James and Edwards (2010), Kirchler (2007) and Richardson and Sawyer (2001). Nevertheless it is possible to outline the main approaches.

The OECD's (2004, p. 37) study entitled *Compliance Risk Management* cites the analysis of James *et al*. (2001) in identifying two main approaches to examining compliance. The first of these shares the assumptions of mainstream economics, that taxpayer behaviour is determined by expected financial gains and losses, and therefore enforcement is based on the use of audits to detect, and penalties to punish, tax evasion. Such an approach will always be an important part of compliance policy but an unduly onerous tax administration may have negative effects. For example, both Strümpel (1959) and Schmölders (1970) reported that the German system was very rigid in its assessment procedures which led to an effective but expensive and confrontational system. A notable outcome "of the relatively coercive tax-enforcement techniques is the high degree of alienation from the state… [which] negatively influences the willingness to cooperate" (Strümpel, 1959, p. 29).

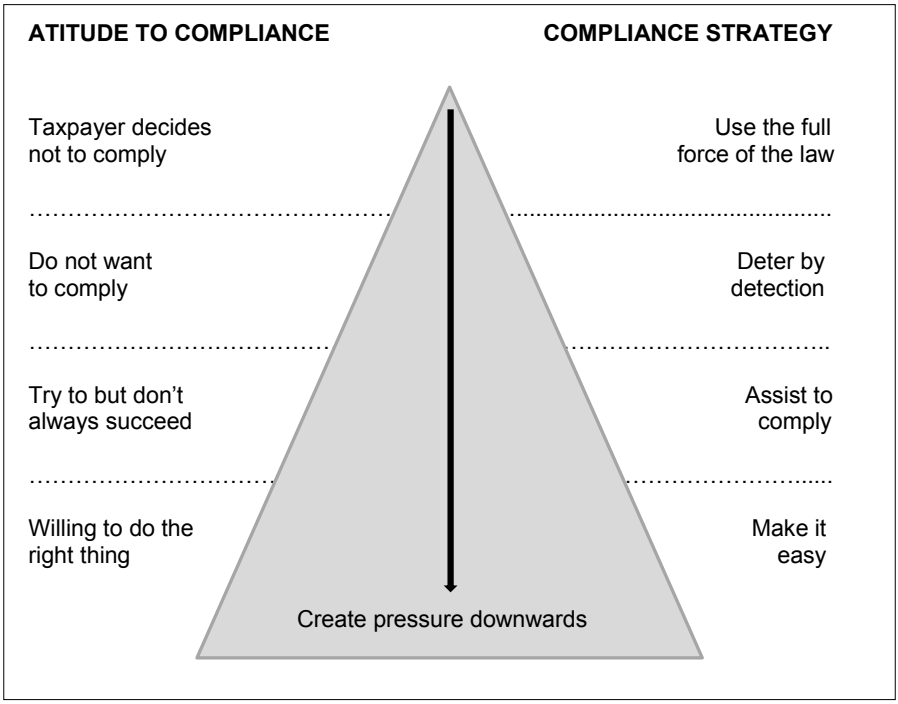
Tax compliance is another area of tax policy where the range of factors and the trade-off between them are not always fully considered. The common assumption referred to above that taxpayers will act in a way that maximises their personal gains also implies that compliance costs should be minimised. However, if the objective of a particular tax is to deter a certain kind of behaviour, then higher compliance costs (and operating costs generally) might ensure that the objective is met. To cite Sandford *et al*. (1989, p. 203):

> *Perhaps the best that can be done is to suggest that the objective might be phrased in terms of minimizing operating costs in obtaining a given revenue from a given tax structure.*

While sometimes acknowledging the wider range of factors and interplay between them, researchers often focus on specifically limited aspects (e.g. Shekidele, 2001 on excise duties in Tanzania; Serra, 2003, on tax administration costs in Chile) – an approach which has led to a second approach to compliance which places more emphasis on a wider range of taxpayer motivations and circumstances. The case for such a 'behavioural' approach is supported by evidence from research in behavioural economics, economic psychology and responsive regulation (see, for example, Alm *et al*., 1999; Bordignon, 1993; Braithwaite, 2003; Cowell, 1992; Cullis and Lewis, 1997; James, 2012c; Kirchler, 2007; Lewis, 1982; Schmölders, 1959; Wenzel, 2004a, 2004b, 2005a, 2005b). A wider approach increasingly permeates the academic literature on tax compliance[11] and there have been many studies that have considered different variables influencing compliance or non-compliance.[12] Findings tend to suggest that contact with revenue authorities and sanctions have an increased effect on the certainty of non-compliance, whereas tax withheld at source, ethics and the probability of detection maintained the same certainty effects and the effect of other variables was ambiguous or had decreased (peer influence and tax rates).

Coming out of this broader approach to looking at compliance, it has been observed that many taxpayers are not wholly concerned with maximisation of their personal gains, but can be expected to act responsibly and willingly meet their obligations without the need for the application of any administrative sanctions. Indeed the penalties for ordinary tax convictions are normally modest and the chances of detection small, yet most individuals pay their taxes (Posner, 2000, p. 1782). So, rather than proceeding on the implicit assumption that taxpayers generally are not to be trusted, the behavioural approach can be seen as supporting taxpayers as responsible citizens. This can be summarised by the compliance model developed in Australia and New Zealand in which it is recognised that non-compliance may occur for very different reasons. This is shown in Figure 3.

Figure 3 Compliance model developed in Australia and New Zealand



Source: James (2012c)

Thus, where taxpayers are determined to evade taxation, the use of the full force of the law is appropriate. In the case of taxpayers who are less determined to evade their obligations, deterrence might be the right solution. For taxpayers who are trying but failing to comply, more assistance is appropriate and for taxpayers who are willing to meet their obligations in full it should be made easy for them to do so. Tax administrations often follow such an approach, but tax research in recent years suggests there is more scope to promote compliance using behavioural insights. Indeed, the UK's Behavioural Insight Team, also known as the 'Nudge Unit', which was set up in 2010 by the UK Government, has already done some work in this area though plenty remains to be done. Interviewee 3 commented that the UK Government is highlighting awareness by a 'we know who you are' approach, similar to the TV licensing campaign some years ago.

More generally, the OECD (2004, p. 8) formally describes compliance risk management as a "structured process for the systematic identification, assessment,

ranking and treatment of tax compliance risks", such as the failure to register or the failure to report tax liabilities properly. The OECD outlines the way a compliance risk management process may be applied by a revenue authority in the following stages:

- identify risks
- assess and prioritise risks
- analyse compliance behaviour (causes, options for treatment)
- determine treatment strategies
- plan and implement stages

In the event of further devolution of taxes, the approach to compliance would necessarily have to remain in keeping with the approach taken across the UK, whereas in the event of independence, the approach to compliance could be completely different, if so desired. For example, under independence a greater focus could be directed towards a behavioural approach or different risks could be prioritised.

Tax harmonisation is, of course, particularly relevant to taxation and Scottish independence or further devolution. The degree to which any country can successfully operate a tax system that is significantly out of line with other countries may be constrained by a series of factors such as globalisation, tax competition and tax harmonisation policies. Rather than defining these as risks, they are better thought of as influencing factors that create boundaries for any tax system. These will be considered briefly in turn.

Globalisation has been defined in various ways. Bhagwati (2004, p. 3) suggested that:

> ...[e]*conomic globalisation constitutes integration of national economies into the international economy through trade, direct foreign investment (by corporations and multinationals) short-term capital flows, international flows of workers and humanity generally and flows of technology.*

This, of course, has major implications for the design of national tax systems. As Sawyer (2004, p. 1), an international authority on such issues, observed:

> *With increasing globalisation of business activity, mobility of capital (and to a lesser degree individuals), and the blurring*

> *of jurisdictional boundaries, the setting of domestic tax policy has taken on an increasingly international application. As a consequence of this international dimension, tax policy and practice cannot, or at least should not, be developed by a country in isolation of the international implications.*

Globalisation requires, or perhaps forces, a high degree of consensus policy and appropriate mechanisms to cater for the innovations it brings, such as the internationalisation of financial markets. Furthermore, globalisation makes it hard to ascertain where a corporation or other enterprise should pay tax, which naturally increases the potential for avoiding disadvantageous tax regimes in particular countries. There is evidence that globalisation has had a significant impact on national tax systems. For example, Messere (2004) observed some convergence in OECD countries both to the level of taxation and to developments in tax structures and Avi-Yonah (2010) found further evidence that different tax systems had been converging over the period 1980 to 2010.

'Tax competition' describes different tax jurisdictions using tax concessions to try to attract businesses, investment and productive individuals to their areas. There is little doubt that taxation may affect all sorts of economic decisions (James and Nobes, 2012) including those regarding location. Therefore it is not surprising that countries might take account of such matters in determining their tax rates. A relevant recent example in the Budget of March 2013 was the further reduction in the UK rate of corporation tax to 20 per cent to take effect from 2015. If Scotland became independent, it would be able to set tax rates to take account of these issues and to attract investment to Scotland. If full tax powers were devolved, it would also have to make economic decisions about how to set tax rates, although these would have to take cognisance of the wider UK tax system. In practice, tax advantages are often not the most important factor in such business decisions and the predicted 'race to bottom' in tax rates has not taken place (see, for example, Plümper *et al*., 2009). However, tax competition is a constraint on countries attempting to levy taxes that are high enough to cause capital and labour to locate or be diverted elsewhere on a significant scale. Interviewee 2 commented explicitly on a change in tax level in Slovakia (a flat tax) attracting foreign direct investment, with the result that Slovakia now has the highest number of car manufacturers in the world based there; an inward investment which had significant economic benefits.

European tax harmonisation might also be a factor influencing Scottish tax design. Nevertheless, it might be less of a constraint than might be supposed since progress towards harmonisation has not been as significant as some might have hoped. The first significant step towards European tax harmonisation was included in the Messina Resolution of 1955 and the Treaty of Rome of 1957 and involved the removal of customs duties between member states. Beyond that, initial moves were very cautious with provisions only for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation was necessary for the operation of the internal market. Since that time there has been a series of reports, reviews and initiatives but not much progress because countries are often reluctant to give up control of taxation which, of course, provides the great bulk of their revenue and is also a powerful instrument of economic and social policy. This is consistent with relevant fiscal principles regarding public expenditure at different levels of government (see, for example, Tiebout, 1956 and James, 2004). Essentially different areas or regions, such as local authorities within the UK or member states within the European Union, may have different preferences regarding the level of public expenditure and its associated levels of taxation. There is also the possibility that different countries may have different preferences regarding the type of tax system they operate. In such circumstances a degree of autonomy would be preferable to a standardised approach.

There are difficulties in finding the right balance between these two perspectives of harmonisation and some degree of national autonomy. In EU terms the first of these, as stated in the preamble to the 1957 Treaty of Rome and many times subsequently, involves an "ever-closer union among the peoples of Europe" and a resolve "to ensure the economic and social progress of their countries by common action to eliminate the barriers which divide Europe". The second perspective flows from the principle of subsidiarity. This is laid down in Article 5(3) of the 2010 Consolidated Version of the Treaty on European Union which states that "in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States".

In terms of harmonisation, the European Commission has made it clear that tax policy must have the priority of supporting the four freedoms of the internal market – the free movement of persons, goods and capital and the freedom to provide services. Tax policy in the European Union must therefore "focus on the removal of tax obstacles to the exercise of those four freedoms" (Commission of the European

Communities, 2001, p. 7). There has been some debate about how this approach fits with the second perspective and subsidiarity. The European Commission (*ibid.*, p. 8) has argued that:

> *There is no need for an across the board harmonisation of member states' tax systems. Provided they respect Community rules, member states are free to choose the tax systems that they consider most appropriate and according to their preferences. The level of public expenditure is equally a matter for national preferences as long as this is adequately met by revenues in such a way that budget positions remain close to balance or in surplus.*

Nevertheless, the Commission goes on to point out that the choices of member states in such matters do not take place in isolation. Furthermore, harmonisation is essential regarding indirect taxes and is specifically provided for in Article 113 of the consolidated Treaty on European Union because indirect taxation might provide an obstacle to the free movement of goods and services and distort competition.

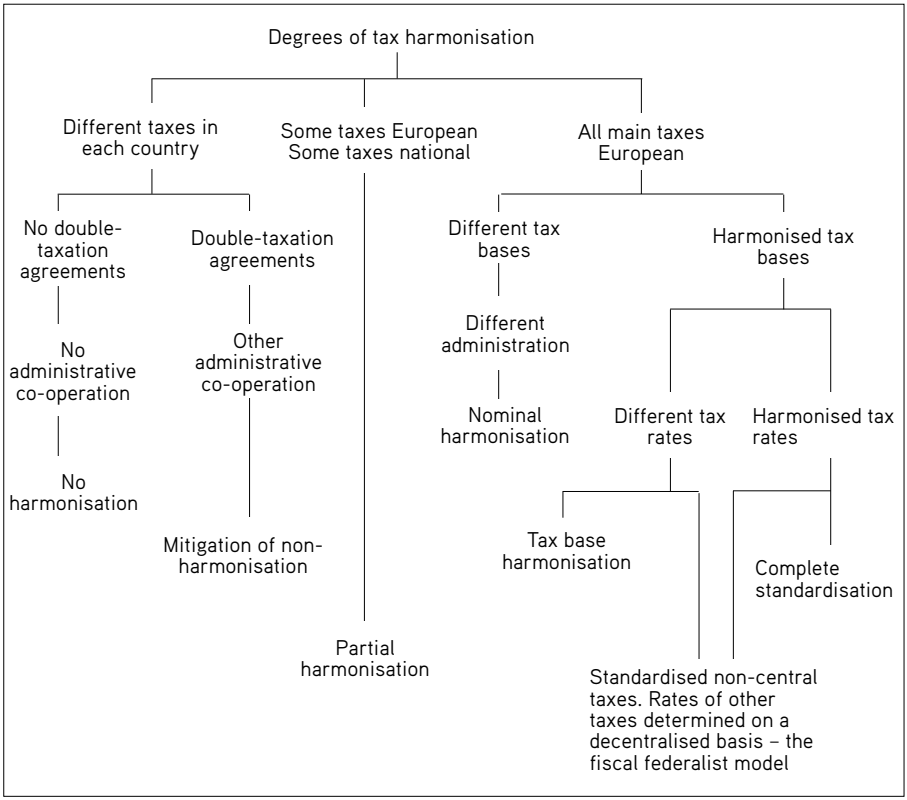
Regarding personal income taxes, while member states in principle may make their own decisions, the Commission argues that it may be necessary to co-ordinate national tax systems to avoid obstacles to the four freedoms. There are similar concerns regarding business taxation. In a later communication, the European Commission (2006, p. 4) identified three principles for co-ordinated tax systems:

- removing discrimination and double taxation;
- preventing inadvertent non-taxation and abuse; and
- reducing the compliance costs associated with being subject to more than one tax system.

The European Commission (2010) has produced a further communication on removing cross-border tax obstacles. This again pointed out that tax rules should not reduce the benefits of the internal market but that such a policy does not require member states to harmonise their tax systems in other respects. However, the subject continues to come up for discussion, for example, regarding responses to tax competition mentioned above, closer economic integration for EU member states generally and, more specifically, fiscal integration of the euro zone countries in an attempt to maintain monetary union in the form of the euro. Further economic integration almost certainly implies a greater degree of tax harmonisation in the future.

So it is not clear quite how far and in what ways tax harmonisation might proceed. Indeed, there has even been difficulty in getting harmonisation of different views on tax harmonisation (James, 2000). It is, therefore, worth examining the dimensions that harmonisation might involve. Figure 4 illustrates various possibilities.

Figure 4 Classification of degrees of European tax harmonisation



Source: Adapted from James (1999)

Following the left hand branch all the way down indicates no harmonisation – different taxes, an absence of double taxation arrangements and no administrative co-operation. This could be mitigated with double taxation agreements and administrative co-operation and this is an area that has been emphasised in EU tax policy. Partial harmonisation could be achieved with some taxes European and some national. The third range of possibilities is where member states all have the

same main taxes but there are choices about different tax bases and tax rates in different countries. Given the benefits of allowing different areas to make decisions that suit their own needs and preferences, European harmonisation that means complete standardisation of taxation across the European Union would seem to be a very unlikely development and would certainly be undesirable. To update an earlier sentiment of Cnossen (1990, p. 473) regarding the European Community, the European Union has been created by and for the member states not the member states for the European Union. In the foreseeable future, European tax harmonisation seems unlikely to be a major constraint to likely changes to the tax system in Scotland following independence or further devolution.

As is clear from the above, there are many different influences upon tax administration and policy which create a variety of risks. However, in terms of policy, it is desirable to have an over-arching framework.

> [W]*hat I've been stressing to the Government officials is, if you do have a policy… if somebody comes up with a question you haven't thought of, you've got a framework by which to say, well, 'Our policy is this, how does it fit in with that?'* (Interviewee 12)

The most obvious course of action would be to develop a strategy to develop policy and implement it, so that matters are not dealt with on an *ad hoc* basis (see James and Edwards, 2007). James and Edwards (2008, pp. 46–49) suggest a ten point plan for a strategic approach to tax policy, which is outlined below.

1. Identify the aims of taxation – for achieving the required range of government economic and social policies, with the importance of all the different aims and objectives being decided on (i.e. traded-off) in regard to the features it is desired that the tax system should display.
2. Identify different methods of achieving the aims – for example, by tax expenditure, by tax subsidy (or by non-tax methods, if these would be better).
3. Analyse in terms of the economic criteria – efficiency, incentives, equity, incidence and macroeconomic considerations.
4. Specify the administrative constraints – what can be done, both legally and practically.
5. Identify different risks – a multilevel assessment is needed to assess the political, economic, social and technological risks in the domestic and international tax environment, and how sensitive such risks are to change.

6. Analyse behaviour – an assessment is needed of how people are likely to react and behave, which may mean that some taxes will be more acceptable than others and thus easier to administer and operate as resistance is less.
7. Relationship with different policies – that is, of tax policy to broader economic and social policies. The need to raise revenue may need to be traded-off against keeping tax rates low to promote economic growth. Tax policy can rarely be changed without impacting on other government policies as well, which thus may also need to be changed.
8. Develop strategies – which should be comprehensive to address wide issues, but sufficiently flexible to deal with particular areas.
9. Plan and implement strategies, including intended outcomes – so that resources are used efficiently and effectively and the various stakeholders are all 'on board'. There should be intended outcomes, with a mechanism for monitoring and evaluating whether the strategies are working.
10. Monitor and evaluate the performance of strategies against the plan – which is by no means easy, given the complexity of any tax administration process. Using the mechanism in nine above, if strategies are not working, then they should be modified, or amended if circumstances have changed. It is likely that there will be several key performance indicators, and the entirety of the tax environment will need to be assessed, especially taxpayer behaviour. The results of monitoring and evaluation generally should be fed back into a continuous review of tax strategy.

The above follows the strategy principles outlined by the management scholar, Henry Mintzberg (2004). Its relevance as a 'recipe' for tax law and system change or *de novo* establishment is clear and is thus germane for the tax implications of further Scottish devolution or independence. However, in the light of changes to tax legislation and systems, consideration will need to be given to the relative validity and standing of existing tax case law and the costs of establishing a revenue infrastructure (establishing offices, training officials, collection machinery and mechanisms, etc.). This could also result in uncertainty (as to how particular laws, case law, mechanisms, etc., would apply or work) and is a further instance of where trade-offs might be necessary.

(viii) What are the insights, processes and learning points from other 'new' countries or regions which have gone through similar developments?

In the transition economies in Central and Eastern Europe and the former USSR, a mixed approach was taken to developing a new tax system, with some countries adopting a 'big bang' approach and some taking a more transitional or a legacy approach (see Martinez-Vasquez and McNab, 1997, for further discussion). What is notable about these approaches is the difference between the bases from which they started. As Interviewee 10 commented:

> *Well, Eastern Europe was, of course, already starting from the proverbial blank sheet of paper. To a degree, Scotland is, but it's a very different blank sheet.*

The point is that the Eastern European countries and Scotland have very different histories which then influence the point from which they start. Perhaps the closest example to potential independence for Scotland from the rest of the UK is the split of Czechoslovakia into the Czech Republic and Slovakia, but even so, the parallels are limited (see Pellegrino, 2004).

> [T]*he Czech and Slovak Republic and the Soviet Union, you know, they had been together for a relatively short period of time. In the case of Scotland… you're talking about centuries, not decades. And I think that that's going to shape the debate with Scotland, depending on what the outcome from the referendum is… Scotland already has quite a high degree of autonomy over its tax system, which is not the case in these other countries.* (Interviewee 13)

> [T]*here are some examples in Eastern Europe, although not all of those are really setting up from scratch. There are examples of countries where the country has been split in two, like the former Czechoslovakia, but my understanding is that they had very much a federal system before the split, and so although there was a change in tax administration, it wasn't an entirely new kind of creation. And then there are places like South Sudan where perhaps there are more challenges than there have been in Eastern Europe.* (Interviewee 14)

When these Eastern bloc countries were part of a Centrally Planned Economy (CPE), where governments had substantial control over all financial transactions, few formal taxes existed and the tax administration was limited. Legacy issues such as distrust of public institutions, corruption and general cynicism towards the government (Ickes and Slemrod, 1992; Martinez-Vasquez and McNab, 1997; Newcity, 1991) are less prevalent in the UK, which also has a different economic culture (e.g. private businesses) and a common law, not civil code legal system. The UK base line is somewhat different with more rigorous tax policy and tax administration systems in place as well as more developed legal and political systems. There is also a well-developed tax and financial profession. Additionally legacy issues are different; whilst there may be issues around public trust and cynicism, there are fewer issues around corruption. It is clear, however, that Eastern bloc countries which have decentralised have taken a long time to set up the necessary tiers of administration to deal with taxation at both national and local levels (Wetzel and Dunn, 2001).

It is unclear whether the ideal tax principles previously discussed will have been considered in depth in many of the countries that have experienced 'fiscal decentralisation'. Dabla-Norris (2006, p. 104), researching the phenomenon across Eastern European and former Soviet bloc countries, comments:

> *A common feature of almost all transition economies is that they began from a legacy of a highly centralised system of public finances with subnational governments acting mainly as administrative units with little independent fiscal responsibility.*

The most that is acknowledged (p. 107) is that "[c]larity, transparency, stability and well-defined rules of the game are paramount for achieving accountability that efficient and sound decentralisation requires", no doubt similar to the "firm principles" deemed desirable by Rodríguez-Pose and Krøijer (2009, p. 409). However, it is worth repeating again that the principles set out by Smith and others remain relevant to the modern world in the context of further devolution or independence for Scotland. Tanzi and Zee (2000, p. 299) comment that developing countries:

> *With emerging markets, and especially… those that aim at becoming integrated with the international economy… should: (1) raise enough revenue to finance essential expenditures without recourse to excessive public sector borrowing; (2) raise*

> *the revenue in ways that are equitable and that minimize its disincentive effects on economic activities; and (3) do so in ways that do not deviate from international norms.*

This is supported in reference to other emerging economies, for example, China (see Krug *et al*., 2004). However, it seems clear in certain instances that states setting up tax regimes 'from scratch' have also opted for policies which have appeared easier. There is, for example, substantial comment on Estonia's adoption of a land tax (see, for example, Malme and Tiits, 2001; Ott, 1999; Tiits, 2006).

However, not all countries have started from the same basis. Ireland's experience of 'lift and drop' from the UK system and Israel's experiences have been discussed under question (v), but many countries have been heavily influenced by their experiences of colonial/imperial rule.

> *The influence of tax designs imported from industrial countries is also visible in a number of cases. Jamaica has emerged from a British colonial heritage, while Bolivia, Columbia, and Mexico have sprung from Spanish colonial origins. In every case the imprint of colonial history is clearly discernible. The Dutch, for example, have left an indelible mark in the public financial structure of Indonesia, as have the French in Morocco.* (Stewart, 2002, p. 9, citing Thirsk, 1997[13])

Australia and New Zealand will have a similar history as former British colonies, but the situations relating to their independence were significantly different in a number of ways from those of contemporary Scotland. Stewart (2002, p. 3, especially footnote 3) also comments on the substantial body of literature available on tax reform projects in developing and transitional countries by reformers such as Vito Tanzi and Richard Bird and the influence of supra-national bodies such as the IMF, World Bank, OECD, etc. However, it seems fair to conclude that, in general, the experiences of other 'new' countries or regions with their tax systems provide few specific lessons that would be immediately applicable without qualification to the tax implications of Scottish independence or further devolution.

(ix) What are the insights, processes and learning points from federal systems, for example, the US or Switzerland?

Before turning to examples of federalism it is useful to examine the concept of fiscal federalism. Martinez-Vazquez and Timofeev (2005) note that there is a broad spectrum of possibilities in a federal system from all taxes (central and local) being collected centrally, to all being collected locally, with a range of options in between. These middle options require a delicate balance between sufficient decentralised power and capacity within the federated states and sufficient power and capacity within the federal state. This balance can be struck at different points depending on political ideology underpinning the federation. For example, there can be shared tax bases where both national and sub-national government have control over tax policy and administration, as in the USA and Canada, or specific bases or taxes can be reserved to the national (India and Australia) or sub-national government (Switzerland) (Martinez-Vazquez and Timofeev, 2005). The underpinning concepts of first-generation theory of fiscal federalism suggest that the main fiscal responsibility in a federal system remains within the federal government, with consideration given to which taxes should be administered by each level of government, and with local government primarily focused on benefit taxes or those that function as such (Oates, 2005). This is developed further by second-generation theory to take account of the political drivers and incentives upon people (particularly state officials) and institutions, and the problems of information.

Boadway (2003) suggests that the benefits of a federal system include the ability to respond to local need, the potential to provide more efficient services than central government and to ensure social and economic equity. Bibbee (2007) comments that an internally coherent system of fiscal federalism requires spending autonomy, revenue autonomy, hardened budget constraints, credible fiscal rules and institutional arrangements for bargaining. Boadway (2003) also notes that a substantial benefit of a federated system is the existence of a central government which can take action to address any unintended consequences or spill-over from the federated arrangements, whether directly or through influencing the sub-national government and to ensure both vertical and horizontal equity so that all citizens, no matter where they live, are treated equally. However, this can also be a challenge of a federal system as the sub-national government becomes over-reliant on transfers from the national government to fund their spending rather than raising the revenue through their own taxes (Oates, 2005, citing Weingast, 1995 and McKinnon, 1997) or the sub-national government shifts the burden for sub-national programmes to the national government through the 'fiscal commons' and soft budget constraints (Oates, 2005). Jochimsen (2008) highlights the over-reliance

of the German Länder on the Federal Government (Bund) as one of the issues within the German federal system. Further consequences which arise from the decentralisation of authority include differences in average incomes, differences in fiscal capacity, spill-over benefits and costs, and fiscal externalities (Boadway, 2003). There is also more than a suggestion that a federal system is a constraint upon state-level revenue maximisation (Feld *et al*., 2010) or economic growth (Hallwood and MacDonald, 2008).

As noted by Martinez-Vasquez and Timofeev (2005, p. 601), there are three elements which must be addressed in relation to the assignation of taxes in a decentralised system:

> *First, what level of government will be granted legal powers to introduce new taxes or change their structure in terms of the definition of tax bases and the determination of tax rates? Second, how will the revenues from the different taxes be shared, if at all, among the different levels of government? Third, what level of government will be responsible for the administration and enforcement of the different taxes?*

Oates (2005, p. 363) suggests that, for a federal system to work well, "[an] economic setting of well developed and efficient markets combined with a fairly decentralized political system, characterized by healthy competition among jurisdiction" is needed.

One of the issues on which all interviewees agreed in terms of federalism was that it would create an enormous degree of complexity. This is typified by the comments of Interviewee 12:

> *Austria's the same, Italy's the same. If… I'm acting for a client who's selling a business across Germany, if I get a VAT ruling in North Rhine Westphalia, it's not going to do me any good in Hamburg or anywhere else… I have to get a ruling in each country. Ditto… in Italy. If I get a ruling in Gorgonzola, that's going to do me no good at all in Lazio. It's a different country. It is a different country. Ditto if I get one in Piedmont, it's no good in Tuscany. They are countries with their own finance ministers…. But, there's no reason why we couldn't basically be a federal UK… there's no reason why Scotland couldn't be in quotes "an independent country within a federal United Kingdom".*

Whether or not there could be a federated tax system within the UK is a question which affects more than Scotland. It is questionable whether a system could be established where there was a federated tax system consisting of rUK and Scotland, as a federated system is predicated on parity between the states and creating parity between rUK and Scotland might be challenging, given the history of the creation and implementation of the union. Also relevant is the issue that both Wales and Northern Ireland already have some level of devolved responsibility for taxation, therefore would the federation be between Scotland and rUK or between Scotland, England, Northern Ireland and Wales? This raises the question, which is beyond the scope of this research, of whether a move to create a federated system would require a complete reworking of the current UK tax system and the wider political system. As Interviewee 2 remarked:

> *I don't think that it's possible to look at a federal system for the UK/Scotland because the power relationship is different. In a federal system each party is equal, but in the UK the power relationship is unbalanced. It's a different power relationship.*
>
> *There are also issues in relation to English consent, for example Scotland couldn't have influence on monetary policy because that would need English consent therefore it couldn't be a federated system. There comes a point when it becomes impossible to manage even though we're good at managing the differences across the UK.*

A key issue in terms of federalism is the process by which this is achieved. The more usual approach is for smaller national units to join together into a federated group, not for a larger national unit to break up into smaller ones. As Interviewee 16 commented:

> *I think the issue with… Switzerland and Germany as I understand it* [is] *they… grew up and merged at a federal level, whereas here we're going in the opposite direction, which I think is quite different.*

The dynamic of the process by which Scotland and the rest of the UK might form a federation is therefore different from what might be considered the 'norm'.

(x) What are the educational (professional and public) needs to support a new system?

As is implicit from the prior discussion, taxpayers' commitment to and acceptance of tax changes are key to their success – though people in general do not much like change.

> [I]*t's fair to say that people don't like change, but if the change is handled correctly I don't think that that is a huge issue.* (Interviewee 8)

One of the valuable things that supports acceptance of change is, as Interviewee 5 commented, that there is "in a modern society… a culture of compliance". This is not always the case for a new system or a new country. Likhovsky (2007) comments, in relation to the establishment of Israel as a new state, on the different attitudes to paying tax held by its influx of new citizens post-1948, dependent on their national origin. For many, non-payment of tax was the norm, as part of a life style or culture which kept them out of sight of government authority. A massive education programme was implemented to change attitudes.

Several of the interviewees commented that there is a considerable role for the tax profession in helping taxpayers get to the 'right' tax bill.

> [I]*f* [tax] *authorities are planning changes, then they really ought to get real and bring the professionals on board and enlist their aid. And, yes, Scotland may have got there already but not all tax authorities recognise professionals. Some view the tax profession as, sort of, leeches to be side-stepped, or whatever, but, like it or not, the professions are there and the reason people use the tax professional is usually because they've got better things to do. It's not as, perhaps the newspapers or many politicians believe, solely… so you can rip off the tax authority. Most of tax work… I've always argued is compliance, i.e. getting to the right tax bill, therefore, the tax professionals have a lot to offer in trying to make sure it* [the system]*… continues to operate.* (Interviewee 10)

Communication to taxpayers and tax professionals is "absolutely key" (Interviewee 9), with websites being very important:

> *I think there would have to be a huge investment in websites and*

that kind of thing, web-based information. These days you can't do anything on any scale without having really good web-based systems, and it took HMRC, as I'm sure you know, several years to improve e-filing, and all the signalling that goes with that… (Interviewee 14)

[T]*hese days, there's an expectation that things will be online and available round the clock, that there's good access to information, as well as payment systems, so communications is a huge practical issue. That needs to be managed well and you need to make provision for the people who can't get online. There is also a choice between something you intend to be seamless to the taxpayer, something like PAYE, where people are often barely aware of it, versus a system that requires people to engage personally with the tax system, and having a clearer understanding of what they're paying and what that tax pays for. That is perhaps more a philosophical than a practical issue, but it has practical implications.* (Interviewee 6)

Such websites are complicated to build and difficult to get right. Also:

People will need access to the law; these days, people expect to have that available online. I guess Scottish law probably is available already on the web and, obviously, that becomes more important the more that it covers. The Scottish Government will have to issue guidance notes and regulations and guidelines and explanatory leaflets and all this sort of stuff. And that's all fine when you have a system that does that, and when you've been building it up for several years, perhaps many years; but it's really challenging, I believe, to do it from scratch. (Interviewee 14)

In a way it's an opportunity to start again on the educational side, because, again, we know in the UK there are so many people that don't understand their obligations under the tax rules. In Scotland in a way they've got the opportunity to start now, starting to educate people as changes are made, you know, and why not bring it into the national curriculum to ensure that people at least have a basic understanding and awareness? (Interviewee 16)

The provision of information will need to be considerably in advance of any changes being implemented – and such information will need to be easily comprehensible to 'the man in the street'. Often tax guidance notes and guidelines are not easily understood. It is also the case, of course, that where tax systems are changed, the educational needs and the costs of meeting them are likely to be substantial.

> [I]*f there's… new legislation…the amount of research and training time… is huge.* (Interviewee 19)

The Scottish Government has already engaged extensively with tax and other professionals in relation to implementation of LBTT and Landfill Tax. This is a model that would be very helpful for future development, as educational and publicity needs, etc., will be similar, regardless of whether devolved taxes or changes under independence are under consideration, although the scale of changes would be different.

The timing of any information provision is also of great importance. Providing information in sufficient time to allow taxpayers and professionals to prepare appropriately is key, but this should not be done before details of the tax or the administration are complete, to prevent concerns about uncertainty.

> *Agents need to be updated on a monthly or quarterly basis. They can backup information to clients i.e. perform an educative role. For example you need to focus on the audience and timing.* (Interviewee 3)

(xi) What would a new system of incentives or penalties to support compliance look like?

The response to questions (vi) and (vii) inherently addressed many of the issues concerning incentives or penalties to support compliance. However, as Interviewee 14 commented:

> [A]*t the very heart of any revenue agency is the ability to identify and register and subsequently tax all the people who ought to be paying tax. In a fully cooperative transfer of powers and responsibilities, you would expect all of the taxpayer registration information to go straight across from HMRC to Revenue Scotland. But if for some reason that didn't happen, then you would have a very big issue about identifying all the taxpayers*

> *because, effectively, you'd be starting from a clean piece of paper in the most unappealing way. And you'd have to... effectively have some kind of tax census in order to identify people, and, clearly, there would be an opportunity for some to slide through the cracks in the floorboards.*

Changes to a tax system involving transfer of information might result in a number of taxpayers escaping the tax net, so there is a risk of evasion. Depending on the nature of changes to the law, there may also be an increased risk of avoidance. Tax evasion and avoidance are issues which affect tax administrations worldwide, whether old or new. There is an extensive academic and professional literature on tax avoidance and evasion. While there may be many definitions possible of tax evasion and tax avoidance, most people familiar with the terms would have no difficulty in accepting those put forward by Simon James (2012a) in his *Dictionary of Taxation*:

> *Tax evasion is the illegal manipulation of one's affairs with the intention of escaping tax. It is traditionally contrasted with legal avoidance of taxation.* (p. 98)

However, tax evasion would also include the tax lost from the hidden economy, also referred to commonly as the 'black' or 'shadow' economy, estimated as worth in excess of £2bn per annum in the UK (Herald, Scotland, 2008). There are no reliable figures for tax loss in transition economies.

> *Tax avoidance describes the rearrangement of a person's affairs, within the law, in order to reduce tax liability.* (James, 2012a, p. 23)

Freedman (2004, p. 336), also defines the latter term similarly as comprising "all arrangements to reduce, eliminate or defer tax liability that are not illegal".

The ways and means of tax avoidance are varied. They range from non-contentious means,[14] through 'post-event damage limitation',[15] preventative means[16] and use of the law to develop contentious schemes, which exploit the form of the law in violation of its intention, spirit or substance.[17] Many books inherently suggest that this type of use of the law began with the 1929 case of *Ayrshire Pullman Services and D.M. Ritchie v CIR* or that of *IRC v Duke of Westminster* in 1936, but 'schemes' go back many years (see Ferrier, 1981). However, notable cases of tax avoidance

in the late twentieth and early twenty-first centuries are characterised by the use of schemes (the cases of *Ramsay (W.T.) Ltd v CIR* and *Furniss v Dawson* being typically cited examples of this). Thus, another way of judging whether taxpayer behaviour constitutes avoidance is whether it is within the spirit as well as the letter of the law (see James *et al*., 2001). However, this rather begs the question as to what actually is the spirit of the law, as this is a nebulous and ill-defined concept. Trying to use it to judge tax behaviour could thus undermine the principle of certainty, which is a fundamental principle (see earlier).

The distinction between tax avoidance and tax evasion is clear in legal, if not in practical, terms, with phrases like 'tax avoision' (Seldon, 1979) being coined to describe the grey area between the two. Revenue authorities may counter such activities from a number of different standpoints, namely:

- the 'spectrum or line' approach, where a boundary is set beyond which activity will be challenged (see Broadbent, 2003);
- the 'smell' test, where transactions are legal but offend the tax authorities (as in avoidance schemes); and
- what revenue authorities might want to achieve, as set out in an online version of HMRC's *International Tax Handbook* in 2007:

> ...[T]*he expression 'tax planning'...embraces a wide range of options from those which are merely 'mitigatory' to those which we would regard as 'avoidance'...* [F]*ine distinctions between 'tax planning' and 'tax avoidance' are seen as being of less consequence than the overall effect on the yield to the Exchequer. This is particularly so where the apparent result is not in accordance with Parliament's intentions or which would not have been, had Parliament addressed itself to the particular issue.*

It is generally thought that the implementation of the *Disclosure of Tax Avoidance Schemes* (*DOTAS*) in the UK in *Finance Act 2004* has filtered out the most contentious tax schemes before they are even instigated. A further weapon against avoidance will be seen in the introduction of the *General Anti-abuse Rule* (GAAR) (Aaronson, 2011), which will attempt both to re-define the 'line' to distinguish tax avoidance from tax planning and provide a lens through which to view and interpret the wider body of tax legislation in the way explicitly set out in the *International Tax Handbook* cited above. However, neither the GAAR nor *DOTAS* can address the tax arbitrage problems whereby multinational firms structure themselves to derive tax

advantages from the interplay of different tax jurisdictions' laws. Such problems are currently the UK Government's focus in its scrutiny of Amazon, Starbucks and Google (see Barford and Holt, 2012).

As it is so difficult to legislate against tax avoidance, various governments in recent years have tried to change public attitudes by a change of terminology or by playing the 'moral outrage card'. This began noticeably in 1997. Peter Wyman, then Head of Tax at Coopers and Lybrand (as was), summarised a development that was clearly in accordance with the intention of the UK Chancellor, Gordon Brown, to attack tax avoidance.

> *Customs & Excise appears now to use the term 'legitimate avoidance' to distinguish between what they clearly believe to be 'illegitimate' avoidance and 'the legitimate desire to organise affairs in a tax efficient way'. These deliberate attempts to confer an aura of illegality to a legitimate activity are dangerous, and should not be allowed to continue unchallenged.* (Wyman, 1997, p. 3)

Depending on any given means of avoidance, it might be these days categorised as 'unacceptable', 'illegitimate', 'illegal' or 'abusive'. 'Illegitimate' and 'illegal' appear odd semantically if avoidance itself remains a legal concept. More recently, there have been calls for people and companies to pay their 'fair share' of taxation, and the UK Chancellor of the Exchequer in his 2012 Budget speech referred to tax avoidance as being "morally repugnant" (Krouse and Baker, 2012). Reduced tax revenue in government coffers, resulting from tax avoidance, means reduced expenditure on public goods and services (e.g. unemployment benefits, hospitals, policing, roads, etc.), which may be seen as unethical.

The issues for Scotland here are manifold, but the basic question would be, under either further devolution or independence, just how much of what might be called the 'tax avoidance' legacy Scotland might wish to retain in terms of applicable case law, legislation, *DOTAS*, GAAR, etc. It would be difficult to separate elements out. For example, a GAAR drafted in the specific context of the UK's body of tax legislation might not fit well with differently drafted legislation, and if deemed desirable, might need to be written anew. However, combating tax avoidance is an issue which Scotland perceives a need to address. For example, Isobel d'Inverno, the Director of Corporate Tax at Brodies LLP, and the Law Society of Scotland's Tax Committee Convenor, interviewed in the *Scottish Legal News* (22 January 2014)[18] commented that "[t]he philosophy underpinning Scotland's taxation plan is both a

vigorous approach to collecting tax and a trenchant attitude towards tax avoidance". Interviewee 16 commented that if Scotland got its compliance approach right, then it would be unlikely to have a significant tax gap and:

> *For Scotland, I think, to some extent, especially when, as they get on to areas like income tax, they have got the opportunity to make the base wider, i.e. by having fewer reliefs and exceptions, etc., and as a consequence potentially having a lower tax rate, which then makes the incentive to avoid tax, evade tax, less attractive.*

However, a large difference between tax rates in Scotland and England might lead to people moving across the border, especially if substantial amounts of tax were involved. Interviewee 12 commented that, while human behaviour might be changed through the use of the tax system:

> *...the thing is, the politicians keep making the mistake of thinking people will behave nicely. But they don't, they just behave in the most greedy, selfish, miserable way they possibly can.*

In addition, as a result of changes, there might be different views held as to the legitimacy of Scottish authorities' right to impose and collect tax, and so might actually foster avoidance and evasion.

> *And it isn't necessarily a given that everyone would see an independent Scottish Government as being just as legitimate as a tax collector as Westminster and HMRC are. And you could see that there might be a greater number of people who might decide that there was an opportunity to game the system, partly because they would perceive, rightly or wrongly, that... the new taxing agency had less experience than its predecessor and was therefore less likely to notice some errors or omissions.*

> *There might be a small group of people who had felt it was reasonable to follow the law in the days when it came from Westminster... who might not necessarily think that the Scottish Government was a good thing and that therefore evading their taxes was almost a moral duty rather than an act of defiance and entirely illegal.* (Interviewee 14)

5. DISCUSSION AND CONCLUSIONS

The tax implications of Scottish independence or further devolution are many and complex, as confirmed in the interviews with leading experts. Furthermore, many of these issues have not perhaps been as fully explored in the public domain as they might have been. The Scottish Government (2013a) states that "the UK tax system is complex and inefficient" (p. 118) and that it intends to develop a new tax system for Scotland "based on the design principles of a modern and efficient system" (p. 122). This is an appropriate starting point, though there are powerful forces that result in modern tax systems often being far from aligned with such principles. In practice other issues may be considered a higher priority than operating the most 'efficient' tax system possible – the issue of fairness being one of the most important. Furthermore, the complexity of modern tax systems is often the result of the underlying complexity of a wide range of domestic socio-economic and international pressures that may influence the development of tax policy. There are processes that may help establish a comprehensive approach to tax policy and administration in a complex and changing environment. One of these is the risk management process regarding tax compliance that has been developed for tax authorities by the OECD (2004). Another is a suggested ten point plan for developing a strategic approach to tax policy which takes account of the different aims, circumstances and risks involved.

More generally, this project set out to clarify the issues by focusing attention on a series of specific questions. The starting point is that where there are significant differences in the preferences or circumstances of populations in different regions within a country, there may be a case for at least some local control over public expenditure and taxation. This is even more likely to be true in the case of a country such as Scotland. To some extent, of course, this has already been recognised. Council Tax is, of course, devolved throughout the UK and the *Scotland Act 2012* permits the Scottish Parliament to set a Scottish Rate of Income Tax (HMRC, 2012) and it will be responsible for Land and Buildings Transactions Tax (replacing Stamp Duty Land Tax in Scotland) and Scottish Landfill Tax. The *Scotland Act 2012* also provides powers for new taxes to be created in Scotland and for additional taxes to be devolved.

The first of the questions posed in this study was 'is the current UK tax system fit for purpose for modern Scotland?' – an obvious starting point, given that Scotland at the date of writing (March 2014) remains subject largely to the same

tax system as the rest of the UK. On most criteria and from the responses of those interviewed for this study, it seems reasonable to conclude that the UK system works reasonably well but there is room for improvement, given the volume and complexity of UK tax law, characterised by multiple tax rates, a lack of coherence in the tax base and discrimination between different kinds of economic activity. There have been many suggestions in different countries that tax systems should be based on sound principles such as simplicity, neutrality, stability and flexibility. However, as suggested above, all tax systems deviate considerably from such principles for a range of important reasons, and there is often a trade-off between these principles. Simplicity is often traded off against equity, resulting in a more complex system – but a more complex tax system can better differentiate between taxpayers' individual situations and between different government policies, though there is frequently a misunderstanding of what 'tax simplicity' means. The importance of equity is vividly illustrated by the example of the Community Charge in Scotland and rUK. Key conclusions to draw here are that the imposition and introduction of new (or reformed) taxes or a tax system should be informed by the principles of 'good' tax design and require legitimation and acceptance by the populace.

Question 2 concerned the practical issues that would arise in developing and administering a new or supplementary tax system. Many such issues would need to be addressed. Key factors would be ensuring an administrative infrastructure, with adequate numbers of appropriately trained staff, supported by effective IT systems – and with HMRC involvement (possibly sub-contracting HMRC staff) to guarantee continuity between 'old' and new' systems. A significant issue under independence would be to clarify what would happen as regards double tax treaties, information exchange agreements, the standing of UK case law, etc. Currently there is considerable uncertainty in legal terms as to whether double tax treaties and other international agreements would need to be re-negotiated: as they stand they exist between the UK (with Scotland being an integral part of the UK) and other countries. This would be crucial for business. Given that a border would exist between Scotland and rUK, another key issue is to determine where individuals and companies are resident for tax purposes.

Questions 3 and 4 related to the design of a tax system for a 'new' country. Once again, it is certain that a system designed on fundamental principles would be subject to a wide range of considerations and trade-offs between competing priorities and issues, especially in terms of equity and efficiency. The literature is divided between whether a 'big bang' approach or a more transitional approach

is more appropriate with suggestions being made that incremental change risks both missing the 'big picture' and losing focus while admittedly being less resource intensive. Establishing how such factors might play out in a Scottish context would require a comprehensive approach to the issue, taking account of how frequent changes in the legal economic and political environment, in government expenditure programmes and in economic and non-economic variables might affect tax policy in terms of such trade-offs and the likelihood of unintended consequences. Indeed, how far a separate Scottish tax system or increased devolution could achieve and maintain a system that is in practice noticeably better in these respects than those in other countries is an interesting point. However, it may be possible for Scotland to do so, if it gave such an aim a higher priority than other considerations that are involved in developing tax policy.

Question 5 asked how long it would take to implement a new tax system and what would happen in any transitional period. This depends, of course, on the changes proposed. The basic options are a legacy approach, retaining a substantial proportion (if not all) of existing taxes and of the current system; a 'big bang' approach to implementing new taxes/system; or some kind of gradual or incremental phasing in of new taxes/system. However, the literature reviewed and interview data suggest that there is a case for incremental change rather than a 'big bang' approach, given the wide range of implications of making immediate tax changes in modern open economies. Such changes would have to work immediately with effectiveness and efficiency, which would imply a need for massive, inherently costly, prior pilot testing or parallel running. Drafting a workable tax code is time-consuming, can take years to implement and requires experienced and trained staff and a supportive infrastructure (administration, IT, etc.). It is difficult to see how this might be achieved without ongoing support from HMRC for a considerable period of time. Even so, the extent of unforeseen problems may still not be sufficiently clear at the outset. An incremental approach will mean that problems will be more manageable as they will not all occur at once.

Implementation issues and the risks involved were the subjects of questions 6 and 7. Key risks in respect of any changed system are whether the desired level of revenue will be raised (with a consequential impact on the level of public services that can be funded); and whether the population will accept the changes, especially the rates of taxes. Thus compliance is a major issue and there are different views on the best approach to be taken. A system may adopt an inherently deterrent approach with severe penalties for non-compliance on the assumption that individuals will act to maximise their gains; or it may adopt an approach based

on insights from behavioural research that suggest that most individuals want to act, and will act, responsibly, if tax authorities themselves behave in a way that encourages this 'co-operative compliance'. There are also global risks, in terms of:

- harmonisation, as any new or changed tax system will need to interface effectively with that of other countries given the level of integration that exists between different national economies;
- globalisation, giving rise to concerns as to where individuals and businesses actually 'belong' and should pay tax; and
- tax competition, whereby tax concessions, including lower tax rates, may be used to attract business, investment and productive individuals to particular countries.

This raises questions of the extent to which the tax system in Scotland could be significantly different from those of other countries without incurring adverse economic effects in the form of undesirable changes to patterns of expenditure or the flows of labour and capital.

Question 8 turned to other countries that had experienced similar developments in taxation. It is not easy to find experiences that closely resemble the particular circumstances of Scottish independence or further devolution. Former UK colonies of substantial size gained independence well before tax administrations took on many of their modern characteristics. The transition economies in Central and Eastern Europe and the former USSR had experienced very different economic and political circumstances which meant some had no choice but to adopt the 'big bang' approach. A lack of administrative infrastructure, distrust of government and public institutions, corruption and a need for swift, practical solutions drove tax developments in ways which would not necessarily be applicable to the Scottish situation. Similarly, legacy systems may or may not be useful where new sovereign states emerge from violent conflict. There is no one model for adopting or developing a new tax system: each country is unique.

Question 9 concerned the learning points from federal systems. This is not immediately applicable to the UK system which does not, of course, have a federal system and which does not fit the model of either Scottish independence or further devolution. While a federal system creates a potential to respond to local needs, it can also lead to over-reliance on transfers from a national government for funding rather than on sub-nationally generated revenues. Federalism also creates a considerable degree of complexity and a potential for different tax rules to be developed which could be detrimental to consistency and clarity. A fundamental

issue here is the process by which federalism might be achieved. The more usual approach is for smaller national units to join into a federated group (not *vice versa*), which has implications for the balance of power between federated parties, as all are (in theory) equal. In theory a federal system would be possible in a Scottish/rUK context and would address other concerns, such as currency union. However the creation of a federation raises wider issues for Scotland and rUK than just tax.

The next issue explored by question 10 is the educational needs, both professional and public, that would be required to support a new system. Clearly the extent of such needs depends on the nature and the scope of the changes proposed, but the view expressed in the interviews is that they would be considerable. Taxpayers' commitment to and acceptance of changes will again be significant in their successful implementation, although it should be noted that the UK basically has a culture of tax compliance (which some states (both old and new) do not have), supported by a tax profession that plays an important role in fostering compliance. Given the means by which information is now disseminated, it would be expected that extensive investment in robust websites would be required to consult individuals, businesses and tax professionals and keep people abreast of changes ahead of and during their implementation. A crucial point is ensuring that as many people as possible understand changes and the consequences for their own behaviour, as often material designed for guidance purposes remains very technical and is not easily understood by non-experts, which reinforces points already made about tax simplicity.

Question 11 asked what a new system of incentives or penalties to support compliance would look like. This built on responses to questions 6 and 7. Key issues would be ensuring that taxpayers do not 'slide through the cracks' in any transfer to new taxes and/or a new system and preventing evasion. Prevention of avoidance would also be a key aim and is tied into measures already referred to previously to ensure compliance, such as retaining or setting a tax rate which does not encourage people to move across the border or 'game the system' by inappropriate behaviour. As Scotland is likely to be affected by the same sort of avoidance issues that now affect all countries, a wider issue is raised of how far Scotland would wish to retain the UK's 'tax avoidance legacy' in terms of legislation, case law, *DOTAS* and a GAAR, and whether reducing opportunities for tax avoidance might also reduce the financial attractiveness of Scotland as a country in which to work or invest, etc. In the interviews it was questioned whether some taxpayers might feel less willing to comply with a new Scottish revenue authority than they have done with HMRC.

In summary, this Report indicates that the tax implications of Scottish independence or further devolution are more complex than may be widely thought. The principles of good tax design are a helpful guiding light in the process of tax reform. Nevertheless, there are many factors that should be taken into account in developing new taxes and administrative arrangements if they are to be successfully introduced. This has been ably described by Bird and Oldman (1990, p. 3) when they suggested that the best approach to tax reform is one that takes:

> *…into account taxation theory, empirical evidence, and political and administrative realities and blends them with a good dose of local knowledge and a sound appraisal of the current macroeconomic and international situation to produce a feasible set of proposals sufficiently attractive to be implemented and sufficiently robust to withstand changing times, within reason, and still produce beneficial results.*

Many of the issues arising under further devolution or independence will be the same: the difference will be the degree or scale. For example, under 'devo-max', as all tax powers would be devolved, in tax terms there would be only a small degree of difference between this and independence. If, however, only a few more small taxes were devolved (e.g. air passenger duty, a 'plastic bag' tax etc.), then there will be a significantly greater difference between this and independence. If Scotland became independent and adopted a legacy approach, this might result in minimal changes. The tax implications and potential are thus dependent in the first place on the degree and extent of Scotland's separation from the UK and in the second on what is possible, desirable and achievable, given the degree of separation implemented.

ENDNOTES

1 See also *Scotland Act 2012 – frequently asked questions* (HMRC).

2 There were several options originally envisaged, ranging from "a position of 'devolution max' – full fiscal autonomy within the UK; creating enhanced devolution; assigning revenues to the Scottish Parliament; [and] continuing with or marginally changing the current framework" (Aitken, 2010, p. 14).

3 Smith's distinguished forerunners, such as Thomas Hobbes and William Petty, as well as his contemporaries and successors, all made a significant contribution to tax theory, for example, writers such as John Locke, Samuel Johnson, David Hume, Edmund Burke, Thomas Paine, Jeremy Bentham, Lord Kames, Sir James Steuart, Thomas Malthus, David Ricardo and John Stuart Mill. Of equal significance are European theorists, such as Jean-Jacques Rousseau, Denis Diderot, Montesquieu, Voltaire, etc., American thinkers, such as Benjamin Franklin and more modern writers, for example, E.R. Seligman, Joseph Schumpeter, etc. (see Frecknall-Hughes, 2007 and 2014 (forthcoming)). However, the constraints of space preclude here any detailed discussion of the various theories of taxation, which include social contract theory (Locke, 1690) – the idea that tax was something paid in return for protection from the state via a voluntary alienation of rights; custom and pragmatism (Hume, 1748, 1752); benefit theory (Smith, 1776; Paine, 1791, 1792); and the concept that tax can only be imposed by law (Bentham, 1793, 1794, 1795, 1798 and c. 1798: Bentham's thoughts on the subject are spread across a number of different works (see Steintrager, 1977; and Dome, 1999)).

4 The extent to which unpopular taxes have played a role in revolts, rebellions and wars is well charted by Burg (2004).

5 Taylor, C.J. (2006), *Beyond 4100: A Report on Measure to Combat Rising Compliance Costs Through Reducing Tax Law Complexity*, Sydney: Taxation Institute of Australia.

6 However, depending on the way forward, significant legal provisions would need to be put in place first. If further devolution were to be implemented, it would require additional UK Parliamentary legislation to allow the Scottish Parliament to set policy as it saw fit within the confines of devolved powers. Under independence, the Scottish Parliament would have the power to start from a 'blank sheet' if it so chose.

7 Where one state secedes from another and becomes independent, the seceding state usually issues a declaration saying that it will be bound by the existing (tax) treaties/agreements that were binding on that other. However, there is no onus on the parties which had formed agreements with that other to accept this and 'extend' such agreements to the seceding state. However, in practice this commonly occurs until such time as the seceding state is able to re-negotiate its own treaties/agreements with these parties. The bargaining power of a seceding state in such circumstances would be an unknown quantity. In theory, an independent Scotland would require a double tax agreement with rUK, but this might be implemented initially by means of both states' domestic law.

8 UK tax case law is, however, used as precedent (persuasive, if not binding) in other common law countries, such as the Republic of Ireland, so it might well remain persuasive in an independent Scotland. Interviewee 7 commented that this would be helpful in terms of continuity, unless completely new provisions were put in place.

9 This theory states that it "is not true that a situation in which more, but not all, of the optimum conditions are fulfilled is necessarily, or is even likely to be, superior to a situation in which fewer are fulfilled" (Lipsey and Lancaster, 1956, p. 12, cited by James and Edwards, 2008, p. 37).

10 See also under question (viii).

11 See James and Edwards, 2008, p. 42, on the various compilations of research on tax compliance.

12 Jackson and Milliron (1986) considered 14 main variables which influence non-compliance: age, gender, education, income level, type or nature of income and whether tax is withheld at source, occupation, peer influence, ethics, fairness, complexity, revenue authority contact, probability of detection, sanctions and tax rates. Further work by Richardson and Sawyer (2001) reviews an additional 43 compliance studies in the context of the Jackson and Milliron study. Richardson and Sawyer also consider research on five additional variables – compliance costs, tax preparers, framing, positive inducements and tax amnesties – and report a mixed effect on compliance. There are many further variables which have been considered: tax morale (Torgler, 2007); cultural influences (Coleman and Freeman, 1997); the implications of different political systems (Pommerehne *et al*., 1994); appeals to taxpayers' consciences (Hasseldine and Kaplan, 1992) and emotions of guilt and shame (Erard and Feinstein, 1994); positive help for taxpayers (Hite, 1989), such as use of television material (Roberts, 1994); use of different forms of communication (Hasseldine *et al*., 2007); consideration of the benefits received from government expenditure (Falkinger, 1988), etc.

13 Thirsk, W. (1997), *Tax Reform in Developing Countries*, World Bank e-library. [Online]. Available at URL http://dx.doi.org/10.1596/0-8213-3999-0. [Accessed 30 January 2014].

14 Such as not buying a good or service on which an excise was imposed; achieving tax-free income by investing in products like Individual Savings Accounts (ISAs) which legislation specifically decrees to be non-taxable; and taking the prophylactic steps allowed by inheritance tax legislation to ensure the devolution of property between generations of a family (currently deemed to be acceptable tax planning).

15 Such as when a transaction potentially liable to tax may be retrospectively claimed to be non-taxable. For example, before the introduction of capital gains tax in the UK, individuals not infrequently would try to claim that a sale of a good/asset had generated a capital, rather than a trading, profit, as a capital profit was then not taxable and a trading profit was.

16 As in the bricking up of windows to avoid the window tax levied in the years 1696–1851 (Dowell, 1884, p. 168). It was not illegal to brick up a window, although bricking up of hearths and chimneys as a way round the very unpopular hearth or chimney tax (1662–1688) was illicit (Marshall, 1936).

17 On what exactly the term 'spirit of the law' might mean, see Freedman, 2011.

18 In an article entitled *Women in the law: Isobel d'Inverno*.

19 This is now proposed in the *Revenue Scotland and Tax Powers Bill* (2013) SP Bill 43. Formal responses to consultation on tax management legislation is currently ongoing (see http://www.scotland.gov.uk/Topics/Government/Finance/scottishapproach/revenuescotland).

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APPENDIX 1 CURRENT TAX REVENUE (EXCLUDING NORTH SEA REVENUE): SCOTLAND 2011–12[1]

	Scotland £ million	Scotland % of total non-North Sea revenue	UK £ million	Scotland as % of UK
Income tax[2]	10,790	23.3%	146,588	7.4%
Corporation tax (excl North Sea)	2,976	6.4%	32,900	9.0%
Capital gains tax	246	0.5%	4,336	5.7%
Other taxes on income and wealth	265	0.6%	2,976	8.9%
National insurance contributions	8,393	8.1%	101,597	8.3%
VAT	9,554	20.6%	109,803	8.7%
Fuel duties	2,296	5.0%	26,798	8.6%
Stamp duties[3]	506	1.1%	8,919	5.7%
Tobacco duties	1,129	2.4%	9,878	11.4%
Alcohol duties	981	2.1%	10,180	9.6%
Betting and gaming and duties	115	0.2%	1,221	9.4%
Air passenger duty	213	0.5%	2,637	8.1%
Insurance premium tax	251	0.5%	3,002	8.4%
Landfill tax[4]	97	0.2%	1,075	9.0%
Climate change levy	64	0.1%	678	9.5%
Aggregates levy	52	0.1%	283	18.4%
Inheritance tax	159	0.4%	2,915	5.6%
Vehicle excise duty	475	1.0%	5,937	8.0%
Non-domestic rates[5]	1,933	4.2%	23,968	8.1%
Council tax	1,987	4.3%	25,964	7.7%
Other taxes, royalties and adjustments	1,028	2.2%	12,831	8.0%

Notes

1 See also Adam *et al.*, 2013, pp. 5-17.

2 Will be replaced by the Scottish Rate of Income Tax from April 2016.

3 Will be replaced by Scottish Land and Buildings Transaction Tax from April 2014.

4 Will be replaced by Scottish Landfill Tax from April 2014.
5 Excludes non-domestic rates which Local Authorities pay themselves.

Source: Adapted from Table 3.1 'Current revenue: Scotland 2011–2012' in Scottish Government (2013b), *Government Expenditure and Revenue Scotland 2011–2012*, Edinburgh: Scottish Government, p. 26. Available at URL: http://www.scotland.gov.uk/Resource/0041/00415875.pdf. [Accessed 28 February 2014]

It is noted that North Sea tax revenue (petroleum revenue tax; corporation tax and license fees) is not included in the above table. Scottish Government (2013b) states that this was £942 million in 2011–2012 (p. 26); however it notes that this is a contested issue (*ibid.*, Chapter 4).

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ABOUT SATER

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SATER's objective is to promote research into, and education of, accountancy, finance and management together with all subjects in any way related. In fulfilling its charitable objectives, it also seeks to provide public benefit by making grants for research projects which result in reliable evidence for use in the development of policy – by professional bodies, standard setters, regulators or governments.

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Further details about SATER and the ICAS research programme can be found from the SATER and ICAS websites: scottishaccountancytrust.org.uk/research.html and icas.org.uk/research.

David Spence
Chairman of SATER
May 2014

The vote on Scottish Independence will take place on 18 September 2014. Irrespective of the result, it is likely that Scotland will eventually have more say over its taxes than it currently does, either through independence or some form of further devolution.

This report, by a team of independent academics, considers the tax implications relating to Scottish independence or further devolution. In line with the apolitical stance taken by ICAS, this report takes no view on the desirability of the various options, but rather sets out to help establish the factors that should be taken into account if change is to be achieved successfully. Whilst focusing on Scotland, some of the issues raised in this report would also be relevant to other jurisdictions that are considering some form of devolution of taxes or the establishment of a new tax system.

The project sought to address, by way of a review of existing literature and interviews, issues such as: the suitability of the current tax system to Scotland; practical issues arising in developing and administering a new tax system; the determining factors for designing a new system; the trade-offs and compromises involved; the time required for implementation; implementation issues; risks; educational needs to support a new system; compliance issues; and insights from other countries.

The report suggests that the tax implications of independence or devolution may be more complex than widely thought, and highlights issues that will need to be considered under both options. Whilst many of the issues arising under further devolution or independence will be the same, albeit to a different scale, other issues identified are specific to independence, such as the design of a new tax system and the status of double taxation agreements.

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