The Tartan Tax: Devolved Variation in Income Tax Rates

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Introduction

THE new Labour Government has published White Papers on devolution to Scotland and Wales,[1] though the proposals themselves differ markedly in that the Scottish Parliament alone will have legislative and tax-varying powers. The plans for Scotland were tested in a pre-legislative referendum held on September 11, 1997; the second of the two questions, on whether voters supported the proposal that the Scottish Parliament should have tax-varying powers, was carried by 63.5 per cent to 36.5 per cent on a 60.4 per cent turnout.

The Scotland White Paper, though not the second referendum question, was explicit that these powers of devolved variation relate to the basic rate of income tax. The fact that there was a referendum, and in particular that there was a separate question on taxation, is undoubtedly a tribute to the success of Michael Forsyth (Conservative Secretary of State for Scotland, 1995–97) in waging a political campaign against the tax-varying power which he evocatively dubbed the "tartan tax". He won this battle about labelling, providing an ironic reminder of the way in which the community charge (of which he was a leading advocate) had been pilloried as the "poll tax" by its opponents. Out of fear that Labour's chances in the 1997 general election were being threatened by Mr Forsyth's seizure of the political initiative, the United Kingdom Labour leadership unilaterally imposed the two-question referendum in June 1996, without consulting either its Scottish leadership or the Scottish Constitutional Convention (SCC) which had developed the devolution proposals. In the event, the May 1, 1997 general election saw the loss of all Conservative seats in Scotland and the election of 66 MPs whose parties were committed to the SCC scheme, with the other six seats being won by the Scottish Nationalists who had campaigned on a platform of independence. The widespread distrust of Labour among its partners in the SCC was then considerably assuaged by the promotion of George Robertson (the erstwhile shadow Secretary of State for Scotland whose credibility had suffered at the hands of both Forsyth and the United Kingdom Labour leadership) to Secretary of State for Defence, and the slotting in of Donald Dewar (who had played a key role in the SCC whilst shadow Secretary of State from 1983–92) as Scottish Secretary.

This article concentrates upon the tax-varying power on income tax, rather than attempting to evaluate the financial arrangements as a package.[2] This variation power is

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[1] Scottish Office, *Scotland's Parliament*, Cm. 3658 (Edinburgh: Stationery Office, 1997) and Welsh Office, *A Voice for Wales*, Cm. 3718 (Cardiff: Stationery Office, 1997).

[2] For such an evaluation, see Heald, D.A. and Geaughan, N., "Financing a Scottish Parliament", in Tindale, S. (ed.) *The State and the Nations: the Politics of Devolution* (London: Institute for Public Policy Research, 1996), pp. 167–83; and Heald, D.A., Geaughan, N. and Robb, C., "Financial arrangements for U.K. devolution", *Regional & Federal Studies* (forthcoming 1998).

proposed to operate only in the case of Scotland, though the possibility of future generalisation to Wales and Northern Ireland should always be borne in mind.

The proposals of the Scottish Constitutional Convention

This section will trace the evolution of the tax-varying power, examining the arguments advanced in its support and considering some of the general criticisms levelled against it. In the later section on "Issues of Tax Design and Implementation", specific technical issues (such as the definition of residence and the taxation of unincorporated businesses) will be addressed.

The SCC's 1990 policy statement proposed that: "There should also be a power for Scotland's Parliament to vary the income tax rate but there should be some range defined so that the variation in income tax up or down cannot be misunderstood as being by a wide margin."[3]

The unexpected[3a] re-election of the Conservative Government in the 1992 general election ruled out all possibility of legislative devolution during that Parliament. However, the SCC continued in existence and published a modified set of proposals in November 1995:

> "Scotland's Parliament will have the power to increase or cut the basic rate of income tax for Scottish taxpayers by a maximum of 3p in the pound. This will give it a greater degree of independence. The power of variation of income tax will be distinct from the formula for equalisation. There will be no question of England subsidising tax cuts in Scotland. Thus, if Scotland wanted tax cuts it would have to pay for them. Similarly, if the Parliament wanted to raise taxes in Scotland, it would be able to keep the revenues for itself. This will ensure a strong sense of financial responsibility. It is worthy of note that what is described here is a power for the Parliament. That such a power will exist does not mean that it will necessarily be used. If the Parliament uses the power to vary the rate of income tax it will be held to account for its decision by the electorate. It is, therefore, a power which is unlikely to be used without a great deal of caution and prudence. Tough decisions will have to be made. But these will be the decisions of the people of Scotland, made by their elected representatives. There will be hard decisions but they will be our decisions."[4]

The major change in the proposed financing arrangements between 1990 and 1995 concerned the dropping—at Labour's insistence—of the proposal for assigned taxes and the introduction of the term "assigned budget" to describe the block grant. However, the principle of the income tax-varying power was unaffected, being calibrated to 3p whereas there had been no quantification in the 1990 SCC plan.[5]

The most comprehensive assessment of the SCC's proposals has been made by the

[3] Scottish Constitutional Convention, *Towards Scotland's Parliament* (Edinburgh: Scottish Constitutional Convention, 1990), p. 16.

[3a] Not by at least one editor of this Journal—Ed.

[4] Scottish Constitutional Convention, *Scotland's Parliament: Scotland's Right* (Edinburgh: Scottish Constitutional Convention, 1995), pp. 27–28.

[5] A tax-varying power on this basis had been proposed during the previous round of debates on Scottish devolution in the 1970s: Heald, D.A., *Making Devolution Work*, Young Fabian Pamphlet 43 (London: Fabian Society, 1976), pp. 30–31. The SCC proposal in 1990 was influenced by a revised version of that scheme: Heald, D.A., *Financing a Scottish Parliament* (Glasgow: Scottish Foundation for Economic Research, 1990).

Constitution Unit, a think tank established by three charitable foundations under the chairmanship of James Cornford. Leaving aside some technical concerns (all of which will be addressed below), the income tax-varying power was strongly endorsed:

> "Powers to raise revenues independently are crucial for the Parliament. ... The *power* to raise additional revenue is important even if it is heavily constrained and even if it is never used (the difficulty of raising direct taxation in an environment where there will always be an election in the offing, either in the United Kingdom or Scotland, should not be underestimated). ... It would not have any significant macroeconomic effects in the United Kingdom as a whole and, so long as it were levied with a clear and accepted purpose, there should be little danger of it introducing incentive effects which distort the Scottish economy. This power has raised an astonishing volume of comment given its relative insignificance in the overall financial settlement. It should be welcomed in principle ..." .[6]

A Stirling University team, led by Professor David Bell,[7] examined alternative methods of financing Scottish devolution. Among the specific comments which they made about the SCC's 3p income tax-varying power are the following:

> "... if used to its maximum extent, an increase of 3p in the pound in the standard rate of income tax would have a significant impact on the Scottish taxpayer. ... The figures [in the illustrative calculation] relate to an employed individual receiving only the single person's allowance. At its peak, the income of someone earning £500 per week would be diminished by more than 2.2 per cent. What they [*i.e.* simulations of the levying of the full 3p] do not suggest, however, is that a 3p in the pound increase in income tax in Scotland will have a cataclysmic effect on the Scottish economy. ... Further, there is no particular reason why the 3p maximum should have been chosen. However, politically it would probably be difficult now to propose a higher ceiling. It would have been possible to plan for a much higher proportion of funding to be tax-based, in order to increase accountability."[8]

Moreover, a study by the Institute for Fiscal Studies[9] on the wider question of financing regional government in the United Kingdom concluded emphatically in favour of there being devolved taxes and indicated a preference that the power of variation should apply to income tax:

> "... some independent power over revenue is essential if the opportunity for regional government to make independent choices is not to be a meaningless fiction. Moreover, to ensure 'accountability' when regional decision-makers choose to set higher levels of spending, it is essential that the additional revenues required to finance any extra spending chosen by independent regional governments should be raised from the regional population, through regional taxes; as little as possible of the tax burden should fall outside the region. ... The first possibility we considered for a

[6] Constitution Unit, *Scotland's Parliament: Fundamentals for a New Scotland Act* (London: Constitution Unit, 1996), paras 287, 289 and 290.

[7] Bell, D., Dow, S., King, D. and Massie, N., *Financing Devolution*, Hume Papers on Public Policy, Vol. 4(2) (Edinburgh: Edinburgh University Press, 1996).

[8] *ibid.* pp. 37, 41, 67–68.

[9] Blow, L., Hall, J., and Smith, S., *Financing Regional Government in Britain*, IFS Commentary, No. 54 (London: Institute for Fiscal Studies, 1996).

source of tax revenue to be placed under regional government control—and, in many respects, the best available candidate—is income tax."[10]

Although the SCC proposals received endorsement from academics specialising in public finance, cracks began to appear in the prolonged run-up to the 1997 general election, particularly after the proposals were analysed by tax practitioners and attacked vigorously by some prominent Scottish business figures and by Conservative Government ministers. An obvious difficulty was the lack of an authoritative mechanism for taking forward the SCC proposals after November 1995, especially when the two main political parties within the SCC were vigorously competing for votes in the anticipated general election. The legitimate but provocatively worded practical issues about the tartan tax raised in March 1996 by Martyn Jones[11] and in February 1997 by Ian Hunter[12] attracted much attention in the Scottish media.

The White Paper proposals

Perhaps the most significant aspect of the White Paper's proposals for tax-varying powers is that it has left the SCC's 1995 scheme largely unchanged. Detail was fleshed out on two important technical matters:

(i) income from savings and dividends would not be included in the tax base; and
(ii) the concern that future changes in United Kingdom income taxation would erode the yield of the tax-varying power was addressed by the proposal that the indexed yield would be protected.[13]

The tax-varying power was variously described by the Scotland White Paper as being "defined but limited" (para. 7.1) and as "defined and limited" (para. 7.2).

Yield of tax-varying power

Searching for estimated yields from tax-varying powers over income tax exercisable by sub-national governments within the United Kingdom severely tests the available data sources. The Scotland White Paper (para. 7.13) stated the yield of each 1p variation on basic rate as "around £150 million" in 1995–96, thereby valuing the proposed power at a maximum of £450 million, in either direction. A Treasury answer to a written parliamentary question provided the further information that the extension of the power to the lower rate would raise £60 million for each 1p variation;[14] the equivalent figure for the higher rate was £30 million.[15] The latest available estimates for the number of Scottish

[10] *ibid.* pp. 35, 51.

[11] Jones, M. H., *A Scottish Parliament and the Tartan Tax*, circular to clients (Edinburgh: Maclay Murray & Spens, March 1996, mimeo).

[12] Hunter, I., "Hidden costs of being Scottish", *Scotland on Sunday*, February 16, 1997.

[13] For example, the introduction of a new 10p band would affect the yield if there were an accompanying change in the width of the basic rate band.

[14] It should be noted that part of this £60 m. yield of 1p on the lower rate relates to those who also pay basic rate and higher rate (£8 m.), part to those who also pay basic rate (£47 m.), and part to those who only pay the lower rate (£5 m.).

[15] Written answer from Dawn Primarolo MP (Financial Secretary to the Treasury) to Bernard Jenkin MP, *Hansard*, col. 514W, July 22, 1997. The cited figures included tax on dividends (savings were not taxed at 20% in 1995–96) in both the lower rate and the higher rate costings. With dividends excluded, the yield of 1p on the lower rate reduces by around £0.5 m. and of 1p on the higher rate by about £3 m.

taxpayers at various bands relate to 1995–96: 500,000 taxpayers whose highest liability is at the lower rate; 1,570,000 taxpayers whose highest liability is at the basic rate; and 170,000 taxpayers whose highest liability is at the higher rate. In total, there are estimated to have been 2,240,000 Scottish taxpayers in 1995–96. The statistical source for such estimates is the annual Survey of Personal Incomes (SPI) which analyses a highly stratified sample of about 80,000 United Kingdom taxpayers, with the principal motive of providing a secure basis for policy advice to ministers on United Kingdom tax changes. It is not territorially stratified, and the sample size is insufficient to support analysis at sub-national level. Moreover, the SPI does not address non-taxpayers, either those who have no income or those whose income is less than the tax threshold. For purposes of comparison, the electoral registers used for the 1997 general election contained 3,984,406 electors in Scotland. On the basis of these figures, 56.2 per cent of electors are themselves income taxpayers and 43.6 per cent are basic rate taxpayers. Naturally, many other electors live in households where there is an income taxpayer. A caveat about these percentages is that those who are familiar with the condition of electoral registers are doubtful about their accuracy, owing to omissions and duplicate entries. Nevertheless, a broad base of taxpayers who are also electors would suffer the burden of an upwards, or receive the benefit of a downwards, variation.

Issues of tax design and implementation

Such a new departure within the United Kingdom tax system will inevitably raise a series of practical issues which must be addressed before such a tax-varying power could be exercised by a Scottish Parliament, due to take over most of the existing functions of the Secretary of State for Scotland from January 1, 2000. The discussion is structured as follows: the effects of the tartan tax on the income tax schedule are characterised; administrative arrangements and costs are discussed, with attention being paid to specific matters such as residence; and the likely economic effects are then considered.

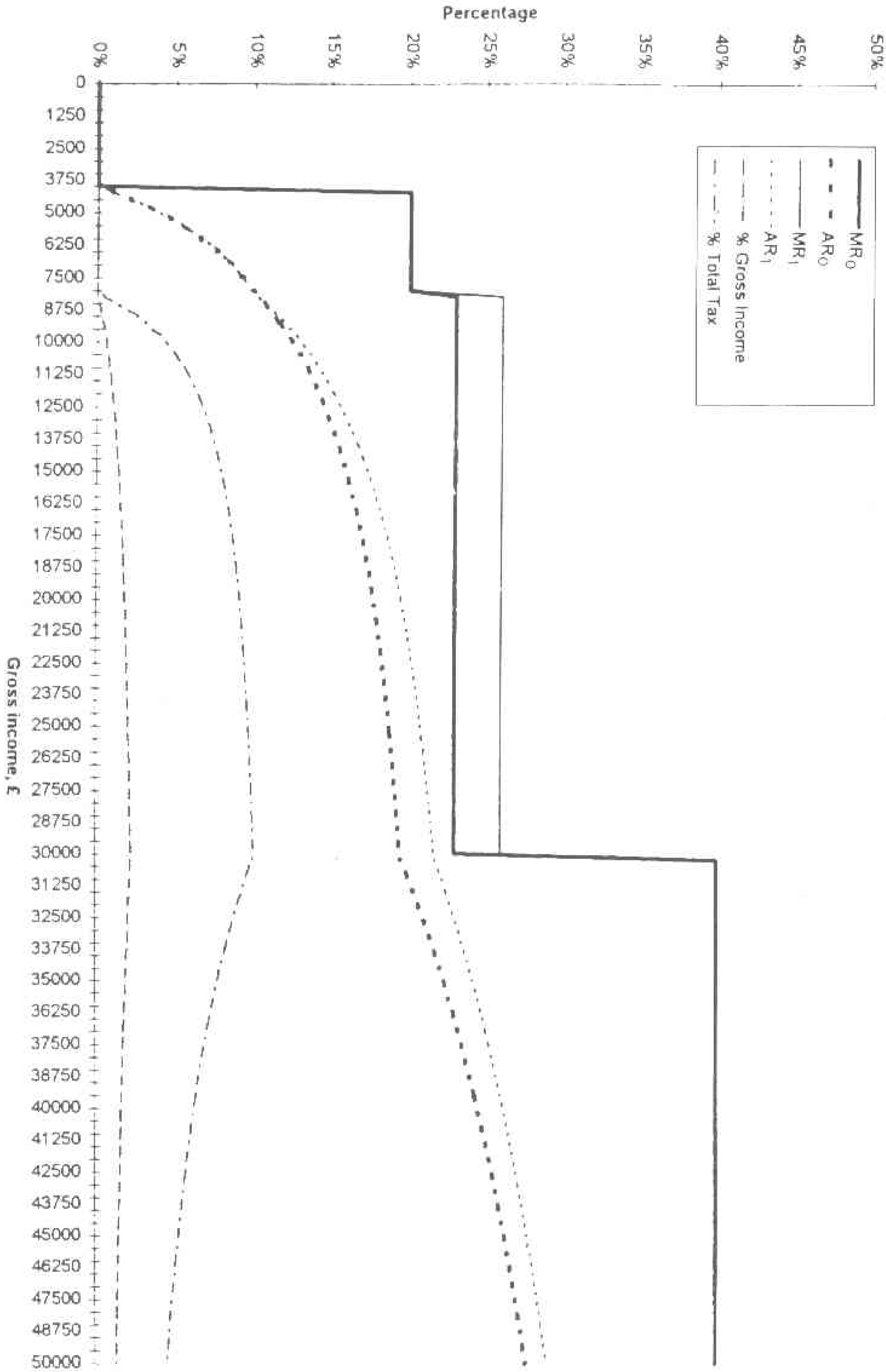
Characterising the Tartan Tax

The most convenient way of characterising the effects of the tartan tax on the income tax schedule is by means of two diagrams.[16] Figure 1 illustrates the tartan tax as proposed by the SCC and confirmed by the July 1997 White Paper (*i.e.* tax variation is restricted to the basic rate) whilst Figure 2 illustrates the effect of permitting tax variation across all bands.

Figure 1 takes for illustrative purposes a Scottish taxpayer with only earned income in 1997–98 and no allowances other than the personal one. Various percentages are plotted on the vertical axis and gross income is plotted on the horizontal axis. In order to simplify exposition, only one case is plotted, that of the full upwards use of the 3p tax-varying power on the basic rate. The solid bold line (MR_0) represents the marginal tax rate when the tax-varying power is not used and the solid feint line (MR_1) represents the marginal tax rate when the full additional 3p is levied. Because the tax-varying power is restricted to the

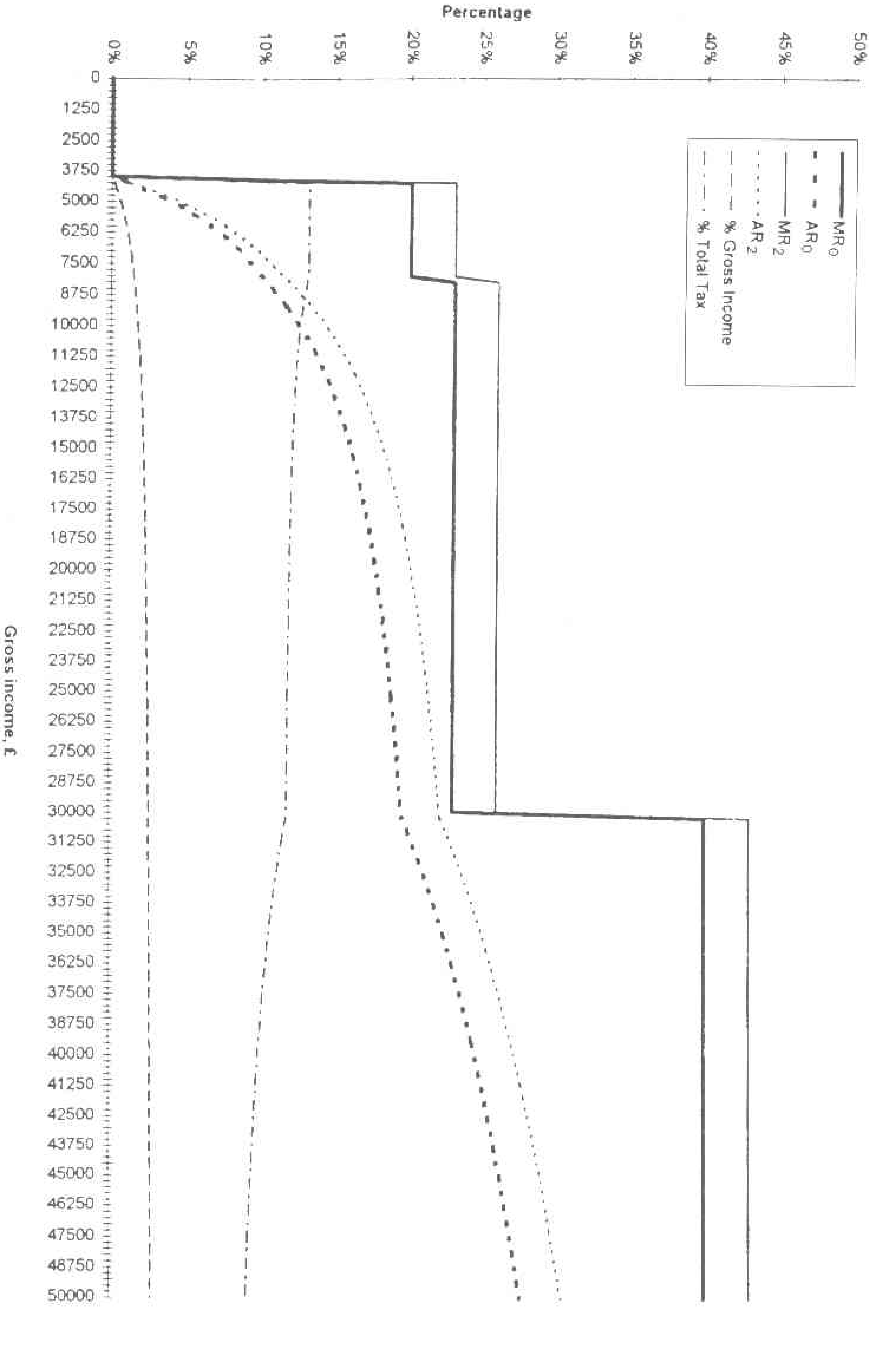
[16] The diagrammatic representation ignores the effect of the upper earnings limit for employees' National Insurance contributions, set in 1997–98 at £465 per week, £2,015 per month or £24,180 per annum. Below this limit, employees other than those contracted out pay 10% of income between the lower and upper limits whilst contracted-out employees pay 8.4%.

Figure 1: Tartan Tax relates only to basic rate



MR_0: Marginal rate without tartan tax.
AR_1: Average rate with tartan tax levied at +3p.
AR_0: Average rate without tartan tax.
% Gross Income: Percentage of gross income taken by tartan tax at +3p.
MR_1: Marginal rate with tartan tax levied at +3p.
% Total Tax: Percentage of total tax bill represented by tartan tax at +3p.

Figure 2: Tartan Tax applies to all taxable income



MR_0: Marginal rate without tartan tax.
AR_2: Average rate with tartan tax levied at +3p.

AR_0: Average rate without tartan tax.
% Gross Income: Percentage of gross income taken by tartan tax at +3p.

MR_2: Marginal rate with tartan tax levied at +3p.
% Total Tax: Percentage of total tax bill represented by tartan tax at +3p.

basic rate band, these two lines coincide except over that band. Similarly, AR_0 (dashed bold line) and AR_1 (dashed feint line) represent the average tax rate without and with use of the tax-varying power. These lines coincide until the basic rate threshold, from where AR_1 rises relative to AR_0, until the higher rate threshold is reached. At increasingly higher income levels above the higher rate threshold, there is a slow convergence.[17] The final two lines on Figure 1 represent alternative ways of viewing the effects of the full upwards exercise of the 3p power: % Gross Income shows the proportion of the Scottish taxpayer's gross income which is taken by the tartan tax, whilst % Total Tax shows the proportion of the total tax bill represented by the tartan tax. Unsurprisingly, both % Gross Income and % Total Tax reach their maximum value at the higher rate threshold.

Figure 2 repeats the analysis for a tax-varying power operating across the whole range of taxable income, thereby extended to the lower rate band and the higher rate band. There are two principal effects of this extension:

(i) the maximum value for % Total Tax (13.04 per cent) occurs over the full width of the lower rate band, then % Total Tax declines as total income increases; and
(ii) % Gross Income increases as total income increases.

Intriguingly, the tartan tax has been characterised as both dangerous (threatening the very vitality of the Scottish economy) and as insufficient (too limited to provide adequate fiscal discretion and accountability). There are several different strands to the argument, and it promotes clarity when these are carefully disentangled. First, the allegedly paralysing effects of the tartan tax will be discussed below under "Economic Effects". Second, criticism of the insufficiency of the tax-varying power is considered in the final section on "Evaluation".

Third, the criticism that it is unfair that the burden/benefit of tax variation should fall primarily on middle income groups will be addressed here. One of the principal criticisms levelled in the pre-election period by Ian Hunter was that higher rate taxpayers would pay a lower proportion of their income as tartan tax than many basic rate taxpayers. There are several reasons why this seemingly sound criticism should be rejected. Most importantly, fairness should usually be addressed at the level of the entire tax system; in this case, it should be noted that, at the higher rate threshold, when taxpayers cease to pay more tartan tax (£660 is the maximum payment), their marginal rate rises from 26 per cent to 40 per cent. The higher rate tax revenue goes into the United Kingdom pool of resources from which will be drawn the assigned Scottish budget. Moreover, the design of a personal taxation system involves a lot of difficult trade-offs, one of which concerns the taxation of mobile labour. Where labour is mobile between jurisdictions, the tax might be shifted backwards to firms which, when they are operating in competitive markets, would not necessarily be able to shift it forwards to consumers. If the tax-varying power had been extended to the higher rate, there would have been endless discussion about the taxation of footballers, snooker players and pop stars. More importantly, there would have been the perception that the Edinburgh financial community, which is in direct in competition with London in labour and output markets, was disadvantaged.[18] Quite apart from the standard public finance argument that progressive taxation should predominantly be a central government power, as a practical matter there are only 170,000 higher rate taxpayers

[17] At the higher rate threshold, AR_1 is 21.70 per cent whereas AR_0 is 19.51%, a differential of 2.19%.

[18] MacQueen, H.L. (ed.), *Paying for Devolution: Proceedings of a Seminar—Edinburgh*, May 28, 1996 (Edinburgh: David Hume Institute, 1996).

in Scotland with an estimated yield of £90 million if the full 3p variation were to be applied to taxable income above the higher rate threshold. At the level of sub-national governments, the redistributive effect will predominantly come from the expenditure side, reflecting how public money is spent.

Administration

It was envisaged that the tax-varying power would be administered by the United Kingdom Inland Revenue. This arrangement was confirmed by the Scotland White Paper (para. 7.18), which estimated the Inland Revenue's set-up costs at "around £10m" and the running costs at "around £8m", though the latter might vary according to the year-on-year change in the variation. Significantly, the costs borne by the Inland Revenue would be reimbursed by the Scottish Parliament. Furthermore, the White Paper committed the Government to publishing a full set-up cost assessment, after the passage of the devolution legislation. Provisionally, the set-up costs for business are estimated to be "around £50 million", with running costs "at around £6–£15 million" (para. 7.19). There will be fixed costs of having the variation power available, and total costs will vary according to the use (*i.e.* year-on-year change) made of that power. By its very nature, administration and compliance costs are bound to be a much higher proportion of revenue yield than applies for income tax revenue as a whole especially if levied below the maximum rate in either direction. However, this is the price which has to be paid for the "fiscal responsibilisation" benefits.

A key issue concerns the definition of residence which the White Paper announced would be the test of liability: "A Scottish resident will be an individual who is resident in the United Kingdom for income tax purposes and who in any tax year spends at least half of his time in Scotland (when in the U.K.) or whose principal home is in Scotland. These concepts will be set out in legislation."[19]

It would therefore be impossible to be judged to be a Scottish resident if not already determined to be a United Kingdom resident. Two of the much quoted difficult cases would easily be resolved. A Scottish MP who spent most of his/her time in London would normally have a principal home in Scotland; the provision, in section 222(5) of the Taxation of Chargeable Gains Act 1992, that a taxpayer can choose which house to nominate as main residence for the purposes of capital gains tax, would not apply here. The North Sea diver whose home is in Colchester is clearly not a Scottish resident; in any case, the place of work in the United Kingdom continental shelf is not treated as being part of Scotland for statistical purposes. Predictably, there will be marginal cases which will attract media attention, some of which may lead to formal appeals; this is true of residence tests both at nation state level[20] and within those nations which have income taxes levied by sub-national jurisdictions.[21] With sufficient determination to make the system work, these practical difficulties are surmountable; indeed, this was the conclusion

[19] Cm. 3658, *op. cit.*, para. 7.16.

[20] Inland Revenue, *Residents and Non-Residents: Liability to Tax in the United Kingdom*, International Series IR20 (London; Inland Revenue, 1996); and Whitehouse, C. *et al*, *Revenue Law: Principles and Practice* (14th ed., London: Butterworths, 1996).

[21] A leading U.S. textbook noted that: "Currently, 41 state governments collect broad-based individual income taxes, and two states (New Hampshire and Tennessee) collect income tax on a narrow base of capital income only", Fisher, R.C., *State and Local Public Finance* (2nd ed., Chicago: Irwin, 1996), p. 413.

of a report commissioned by the Constitution Unit in early 1997 from a former Deputy Chairman of the Board of Inland Revenue.[22]

Two technical issues regarding the definition of the taxable base to which the variation power would be applied had to be resolved before the publication of the White Paper. First, income from savings and dividends was excluded, on the challengeable grounds that consistency of treatment was necessary across the United Kingdom. Since 1996–97, savings income has been taxed in the United Kingdom either at the lower rate (for both lower and basic rate taxpayers) or at the higher rate. As Scottish residents would receive interest and dividends from United Kingdom as well as Scottish institutions, the practicality of applying the tax-varying power to this source of income was in doubt. Moreover, Scottish-based financial institutions were undoubtedly nervous that non-Scottish residents whose assets they managed might mistakenly believe that their funds would be subjected to the tartan tax. This decision does mean that the composition by source of a Scottish taxpayer's income will affect tartan tax liability, with the bias being against earned income.

Second, the decision was taken not to exclude from the tartan tax base the taxation of unincorporated businesses. In any case, the traditional alignment between the basic rate of income tax and the small companies rate of corporation tax has been broken at the United Kingdom level, with the respective rates now being 23 per cent and 21 per cent. With the full upwards use of the tax-varying power, these would become in Scotland 26 per cent and 21 per cent, providing an incentive to incorporation. However, with the tax-varying power restricted to the basic rate, thus capping the maximum liability at £660, the view has been taken that costs associated with incorporation will limit the practical importance of this tax incentive. Similarly, restricting the power to the basic rate minimises the potential difficulty concerning the taxation of Scottish-based partners on their share of the United Kingdom-wide profits of their partnerships.

Economic effects

Public discussion about the economic effects of the tartan tax has oscillated between "tax horror" (Scottish competitiveness will be destroyed) and "irrelevance" (the proceeds of full utilisation are small beer). The Bank of Scotland plc and Scottish & Newcastle plc are two companies headquartered in Scotland whose chairmen have consistently warned of dire consequences:

> "The proposal of fiscal powers for the proposed Assembly to vary the basic rate of income tax by up to 3p in the £ is controversial and, in our view, many serious collection, administrative and motivational problems remain hidden. For these reasons, the likelihood later of a switch in focus to some form of tax on goods and services or an additional Scottish sales tax must become a distinct possibility. 'Competition is King' throughout the United Kingdom marketplace and the consequent reinvigoration of the United Kingdom economy is apparent for all to see. Any form of additional regional tax can only handicap Scottish business and commerce and discourage vital investment by United Kingdom and overseas companies—and thus the all important creation of wealth and jobs. The entire

[22] Beighton, L., *Scottish Devolution: The Proposed Revenue Variation Power*, February 1997, mimeo.

> Scottish electorate will need to think very seriously about the risk of adverse consequences flowing from any such tax over the longer term."[23]
>
> "The implications for our Company of any new and progressive deterioration in any aspect of Scotland's domestic and international competitiveness might be to limit levels of investment and employment in this our home market and to impair our ability to meet competition from companies not so burdened. The electorate might view the power to levy taxes by any Assembly as initially, at least, a theoretical question. In our judgment this power, if granted, might lead to the eventual creation within Scotland of conditions which would inhibit the recruitment and retention of talent, bias investment decisions towards other areas of the United Kingdom and make Scottish goods and services significantly uncompetitive."[24]

In sharp contrast, the conclusions drawn by modellers of the Scottish economy suggest that the predicted macroeconomic effects of the tartan tax would be modest:

> "If the Scottish people genuinely wish increased government expenditure in Scotland and, importantly, if they are prepared to pay for this in the form of higher income taxes without seeking compensating changes in their gross wage, then the fiscal innovation of the 'tartan tax' may have significant beneficial effects on employment, output and migration. However, even in the worst likely scenario [full compensating changes in gross wages] the adverse macroeconomic impact is relatively small and spread over a considerable time period."[25]

Geography plays a significant role; the Scotland/England border is relatively sparsely populated and there are limited numbers of cross-border commuters. In contrast, the Wales/England border at both its north and south ends cuts across east–west corridors through which flow people and economic activity.

Evaluation

First, the successful design and implementation of tax-varying powers will be important not only in the context of devolution to Scotland (and possibly later to Wales and Northern Ireland), but also, for its wider relevance for local government finance throughout the United Kingdom. There has been substantial criticism of recent centralising processes from a broad spectrum of political opinion. Whereas centralising factors are partly economic in origin, leading to more Vertical Fiscal Imbalance (VFI) (revenues are further concentrated in the hands of central government), they are also the (sometimes unintended) consequences of policy choice. Sub-national governments cannot be fully self-financing both because most of the least distorting taxes must be entirely or primarily levelled at the United Kingdom level (a feature of VFI) and because of the requirement for Horizontal Fiscal Equalisation (jurisdictions differ markedly in their taxable capacities and expenditure needs). Nevertheless, it is proper that attention is paid to the marginal fiscal incentives facing public decision-makers. This is the primary reason why business critics of the tax-varying power are misguided. It should not be forgotten that the repealed

[23] Sir Bruce Pattullo, in his Governor's Statement in the Bank of Scotland plc's *Report and Accounts 1997*, p. 9.

[24] Sir Alistair Grant, in his chairman's statement in Scottish & Newcastle plc's *Annual Report and Accounts 1997*, p. 2.

[25] McGregor, P., Stevens, J., Swales, K. and Yin, Y.P., "The economics of the tartan tax" (1997) *Fraser of Allander Quarterly Economic Commentary*, 23(3) pp. 72–87.

Scotland Act 1978 was much criticised for the absence of taxation powers which would be conducive to fiscal discipline; the work of the SCC can be viewed as a sustained effort to draw lessons from the shortcomings of the 1978 scheme.

Second, if the devolved variation power is not used reasonably soon after the establishment of a Scottish Parliament, it is likely to atrophy. There is a United Kingdom precedent in the unused powers to lower personal taxation contained in the Government of Ireland Act 1920; however, the circumstances were highly specific to the financial condition of Northern Ireland.[26] The Inland Revenue will have to gear itself up and employers throughout the United Kingdom will have to identify those employees who are Scottish residents; in practice, their tax codes are likely to have a suffix S and employers will be instructed to use a different set of tax tables for them. If the tax-varying power is not used, the state of preparedness will decline and case law will not develop. Moreover, it will become more politically difficult to implement if left unused. Resistance to both reimbursing the Inland Revenue's administration costs and to imposing compliance costs would undoubtedly grow. People are well aware that levels of council tax differ across areas and will become accustomed to the same notion with regard to income tax; the modest nature of the power and the limited effect on most people are relevant. There are already signs of an emerging debate on the circumstances under which the power would be used, with mixed messages coming from Scottish Office ministers (Donald Dewar suggesting that it would be applied only for special projects and his deputy, Henry McLeish, suggesting more general use). Labour members of a Scottish Parliament would be bound for the first two years by Labour's 1997 general election pledge not to increase personal tax rates during the lifetime of the Westminster Parliament. Nevertheless, there is a crucial distinction between a Parliament having powers and a political party planning whether or not to use them; for example, the Liberal Democrats have explicitly transferred their national pledge of 1p on income tax to fund education to the Scottish setting.

Third, the tax-varying power is variously criticised as being too large or too small. In an ideal world, the Scottish Parliament would raise a higher proportion of its own revenue. In the actual world, there has been considerable difficulty in sustaining the power envisaged in the SCC's 1990 and 1995 schemes. Over that considerable period, there have been important developments in the taxation system,[27] including the introduction of independent taxation in 1990–91 (which increased the yield) and the on-going break-up of the basic rate into 23 per cent, 20 per cent and perhaps 10 per cent bands (which has reduced the yield). There remain outstanding questions about the mechanics of protecting the indexed yield of the tax-varying power, including the index to be used (which could relate to the RPI, earnings or General Government Expenditure) and about the possibility of a specifically Scottish band (stretching some way above the higher rate threshold or down into the lower rate band) to offset any narrowing of the basic rate band.

[26] Under the Government of Ireland Act 1920, the Parliaments of Southern and Northern Ireland were granted a remarkably general power "to grant relief from income tax and super-tax or either of those taxes to individuals resident and domiciled in Southern Ireland and Northern Ireland respectively and such relief may be given either generally to all such individuals or to individuals whose total income is less than such amount as may be determined by the Act granting the relief" (s.25(1)). See Lawrence, R. J., *The Government of Northern Ireland: Public Finance and Public Services, 1921–64* (Oxford: Clarendon Press, 1965).

[27] Lazarowicz, M., "Giving a Scottish Parliament powers to vary taxation", paper presented to the John Wheatley Centre Governance of Scotland Project Seminar on "Financing Scotland's Parliament", Edinburgh, May 23, 1997, mimeo.