

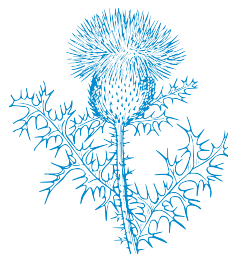


Institute for Fiscal Studies

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The Scottish Government's record on tax and benefit policy



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Scottish Election Briefing Note 3

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Executive summary

Recent years have seen the Scottish Government gain – and make use of – a range of new tax and benefit powers, to add to the powers it has had over council tax and business rates since the advent of devolution in 1999. Devolved taxes now account for around 30% of all tax revenue raised in Scotland, and devolved benefits almost 20% of all benefit and tax credit expenditure in Scotland.

Are there any common themes in how the current Scottish Government has used these powers? Who are the winners and losers from the reforms it has undertaken? What opportunities has it taken and what difficult decisions has it ducked? And what are some of the key issues for the coming years?

Key findings

- 1 There is a common theme to the tax and benefit reforms introduced by the Scottish Government. Both over time and relative to the rest of the UK, they have made the system more generous to the less well-off while raising more revenue from the better-off. Changes to income tax, social security benefits, council tax, and land and buildings transaction tax (LBTT) on housing have all contributed to that pattern. Business rates and LBTT on business property are also targeted more at high-value properties, though that does not necessarily imply the burden falls more on high-income households.
- 2 The reforms have tended to complicate the tax system, introducing more rates and bands into income tax, business rates and LBTT as well as several new reliefs in business rates. The additional complexity in income tax is unnecessary: a very similar and indeed slightly more progressive pattern of tax payments could have been achieved by applying a 21% rate above a new 0% income tax band, rather than having three separate rates (19%, 20% and 21%).
- 3 Council tax increased between 2016–17 and 2020–21 after nine years of freezes and has been made less regressive by increasing the tax

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rates that apply to properties in Bands E to H. But, like the UK government in England, the Scottish Government has failed to grasp the nettle and introduce much-needed fundamental reforms, most notably to update property valuations that are now 30 years out of date.

- 4 A range of targeted business rates reductions provide immediate support to hard-pressed businesses and will promote development of commercial property. But in the long term the main effect is likely to be higher commercial rents than we would otherwise see, benefiting landlords more than reducing the overall cost of premises.
- 5 The election campaign and coming parliamentary term are likely to see significant debate about further tax devolution – with the current Scottish Government having called for the devolution of National Insurance, capital gains tax and the remainder of income tax. Doing this would mean Scottish income tax changes applied to all income – reducing the scope for tax avoidance – and allow the Scottish Government to address inefficient and unfair differences in tax treatments between different forms of income. However, such radical reforms would create many losers as well as winners and the current Scottish Government has shied away from radical reform in the property tax sphere, where the requisite powers are already devolved.
- 6 The current Scottish Government has also suggested that VAT could be devolved now that the UK has left the EU (whose rules prevented this while we were a member). However, the way VAT is calculated and collected means devolution would entail significant additional administration costs and compliance costs, especially for businesses with operations on either side of the Scottish border. Only if Scottish preferences on VAT policy differ significantly from those in the rest of the UK would it seem worthwhile incurring these costs.
- 7 The main giveaways to low-income households have come not from the small cuts to income tax but from the introduction of a number of new benefits and top-ups to existing UK-wide benefits. These include a top-up to carer's allowance, more generous housing benefit for those in social housing who have what the UK government deems to

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be 'spare' bedrooms, and extra payments for families with young children on means-tested benefits. These will boost the incomes of the poorest fifth of Scottish households by an average of almost 1.5% this year.

8 The Scottish Government's changes to universal credit – giving recipients more flexibility in how they are paid – and planned changes to the process of assessing entitlement to disability benefits should both make life easier for claimants. The test will be whether the admirable intentions and welcome direction of travel are reflected in improved performance in practice.

9 Taken together, the changes in devolved tax and benefit arrangements during the current parliament are progressive. Using Scottish rather than rUK rates of income tax and benefits, combined with real-terms changes to council tax, cost Scottish households £270 a year on average (0.8% of their average income), but that rises to £1,940 a year (2.4% of income) for the highest-income tenth while on average the lower-income half have gained.

10 As well as these permanent changes to taxes and benefits, the Scottish Government has provided some temporary support to help with the COVID-19 crisis in areas where policy is devolved. Like the UK government, it introduced significant and well-targeted business rate reliefs for hard-pressed firms, and LBTT relief to stimulate the housing market – but more of the former and less of the latter than the UK government. It also announced additional payments for carers, those getting free school meals and those getting means-tested council tax discounts, the biggest of which are still to come.

1. What tax and benefit powers are devolved to Scotland?

The Scottish Government has set council tax and business rates policy since the advent of devolution in 1999. It also had the power to vary the basic rate of income tax by up to 3 percentage points between 1999 and 2015, although it never made use of this.

Following the Calman and Smith Commissions,¹ recent years have seen the Scottish Government and Parliament gain and make use of a wider range of powers over tax, as well as parts of the benefit system. Table 1.1 summarises forecast revenue and spending for devolved taxes and benefits for the year just ended, 2020–21.²

Table 1.1. Scottish devolved taxes and spending

	Amount (2020–21, £ million)
Taxes	
Land and buildings transaction tax	517
Scottish landfill tax	95
Income tax	11,850
Business rates	1,848
Council tax	2,607
Benefits	
Admin. by UK government	3,006
Admin. by Social Security Scotland	322
Admin. by Scottish LAs	167

Note: The figure for spending administered by Social Security Scotland includes spending by the UK government on disability living allowance for children, which is transitioning to the new Scottish child disability payment.

Source: Scottish Government, 2020; Scottish Fiscal Commission, 2021.

¹ Calman Commission, 2009; Smith Commission, 2014.

² Council tax revenue forecasts for the year just commenced, 2021–22, are not available at the time of writing.

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On the tax side, the Scottish Government has powers over:

- The taxation of land and property transactions. In Scotland, this is enacted via land and buildings transaction tax (LBTT), which is forecast to have raised £517 million in 2020–21. This power was devolved in 2015–16.
- Taxation of landfill disposal, via the Scottish landfill tax. This is forecast to have raised £95 million in 2020–21 and was also first devolved in 2015–16.
- Income tax rates and bands (though not allowances) for income other than savings and dividend income. These are forecast to have raised £11.9 billion in 2020–21, and the power to set these rates and bands was first devolved in 2017–18.³
- Business rates, which are forecast to have raised £1.8 billion in 2020–21.
- Council tax, which Scottish local authorities (LAs) set the headline ('Band D') rate of, and which is forecast to have raised £2.6 billion in 2020–21.

Taken together, these represent approximately 31% of all tax revenue raised in Scotland. Agreement has also been reached in principle to devolve powers over air passenger duty (forecast to have raised £100 million in Scotland in 2020–21) and the aggregates levy (£60 million)⁴ and to allocate half of VAT revenues raised in Scotland (£4.8 billion) directly to the Scottish Government. Some steps have been taken towards this: in 2017, the Scottish Parliament actually got as far as legislating to introduce an air departure tax in place of the UK's air passenger duty (though the Scottish Government dropped the SNP's 2016 manifesto plan for the tax to be halved, recognising the environmental consequences of such a cut). However, legal and technical issues have so far prevented devolution (or assignment of revenue) being implemented in practice for these three taxes.

On the benefits side, most benefits remain the responsibility of the UK government but powers have now been devolved to the Scottish Government over:

- Disability benefits (disability living allowance, personal independence payments, attendance allowance, severe disablement allowance and industrial injuries benefit – though not employment and support allowance, an earnings-

³ The power to vary income tax rates in lock-step was devolved in 2016–17.

⁴ Office for Budget Responsibility, 2021.

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replacement benefit for those unable to work because of ill health or disability, or the disability components of universal credit).

- Carer's allowance, for those caring for people with a disability.
- Various occasional payments: winter fuel payments, cold weather payments, funeral expenses payments and maternity grants.

The Scottish Government has some limited powers over universal credit – particularly over the way it is paid and the way the housing element is calculated.

It can also provide top-ups to UK benefits, and has control over discretionary housing payments and other discretionary schemes (such as the Scottish Welfare Fund) which are administered by local authorities.

So far, the Scottish Government has replaced some smaller UK benefits (such as introducing Best Start grants in place of the Sure Start maternity grant). But for the main disability and carer benefits, it is currently in the process of designing its own new schemes for roll-out in the next parliament. In the meantime, these benefits continue to be operated by the UK government according to UK government rules (though the Scottish Government is responsible for funding them), and the Scottish Government is temporarily using ad hoc top-ups to deliver particular policies (introducing a carer's allowance supplement, and using discretionary housing payments to effectively eliminate the under-occupation penalty or 'bedroom tax'). We discuss each of these policies below.

In total, the Scottish Government had responsibility for funding approximately £3.5 billion of benefits expenditure in 2020–21, of which:

- Approximately £3 billion was on disability-related benefits which are currently administered by the UK government according to UK-wide rules (pending the roll-out of Scottish replacements).
- Approximately £320 million was on benefits administered by Social Security Scotland according to Scottish Government rules, including a range of child-related benefits and a top-up to the UK government's carer's allowance.
- Approximately £170 million was on benefits operated by Scottish LAs, including discretionary schemes.

2. Income tax is higher and more progressive than in rUK, but unnecessarily complicated

The Scotland Act 2012 and Scotland Act 2016 greatly expanded the powers devolved to the Scottish Parliament to set its own income tax rates and bands (though not the tax-free personal allowance) for residents of Scotland, except for income from savings and dividends, which continue to be taxed at UK-wide rates. Scotland has used these powers to set slightly different rates and bands from the rest of the UK (rUK). Table 2.1 shows the current income tax bands and rates in Scotland, along with the number of people in each band; Figure 2.1 shows how the rate schedule compares with that in rUK.

The most eye-catching changes in Scotland have been to tax rates: the introduction of two new bands, taxed at 19% and 21%, either side of the 20% basic-rate band, and 1 percentage point increases in the higher and additional rates of tax.⁵ The biggest difference from the rest of the UK, however, is in the higher-rate threshold. It has risen by only 1.5% since being devolved, from £43,000 to £43,662 – not even keeping up with inflation – whereas the UK government has increased it to £50,270 in the rest of the UK. The March 2021 Budget committed the UK government to freezing the higher-rate threshold (along with other personal tax thresholds) up to and including 2025–26; a question for the next Scottish Government will be whether to follow suit and freeze the higher-rate threshold in Scotland or to allow inflation to narrow the gap between Scotland and rUK.

Figure 2.2 shows the difference between income tax liabilities in Scotland and rUK at a given income level. The 19% starter rate means that taxpayers with incomes below £27,393 – just over half of Scottish income taxpayers – pay less income tax in Scotland than they would in the rest of the UK. But the difference is small: the maximum gain in 2021–22 is £20.97, which applies to those in the Scottish basic-rate band, i.e. with income between £14,667 and £25,296. Those in the starter-rate band or near the bottom of the intermediate-rate band gain less than this, as do those

⁵ Increasing the higher rate to 41% also means that the effective tax rate between £100,000 and £125,140, caused by the withdrawal of the personal allowance, is 61.5%, compared with 60% in the rest of the UK.

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in receipt of means-tested benefits, who see their higher after-tax income partly offset by reduced benefit entitlements.

In contrast, those with higher incomes pay significantly more tax in Scotland than they would in the rest of the UK – a result of the lower higher-rate threshold in Scotland as well as the higher rates. Someone on £50,000, for example, will pay £1,494 more income tax in Scotland than they would in the rest of the UK. And someone on £100,000 will pay £2,048 more income tax.

Table 2.1. Income tax rates and thresholds in Scotland, 2021–22

Income	Band	Rate	Number of adults, 2018–19
£0 – £12,570	Personal allowance	0%	1,995,000
£12,570 – £14,667	Starter rate	19%	257,000
£14,667 – £25,296	Scottish basic rate	20%	1,043,000
£25,296 – £43,662	Intermediate rate	21%	888,000
£43,662 – £150,000	Higher rate	41%	322,000
£150,000+	Top rate	46%	15,000

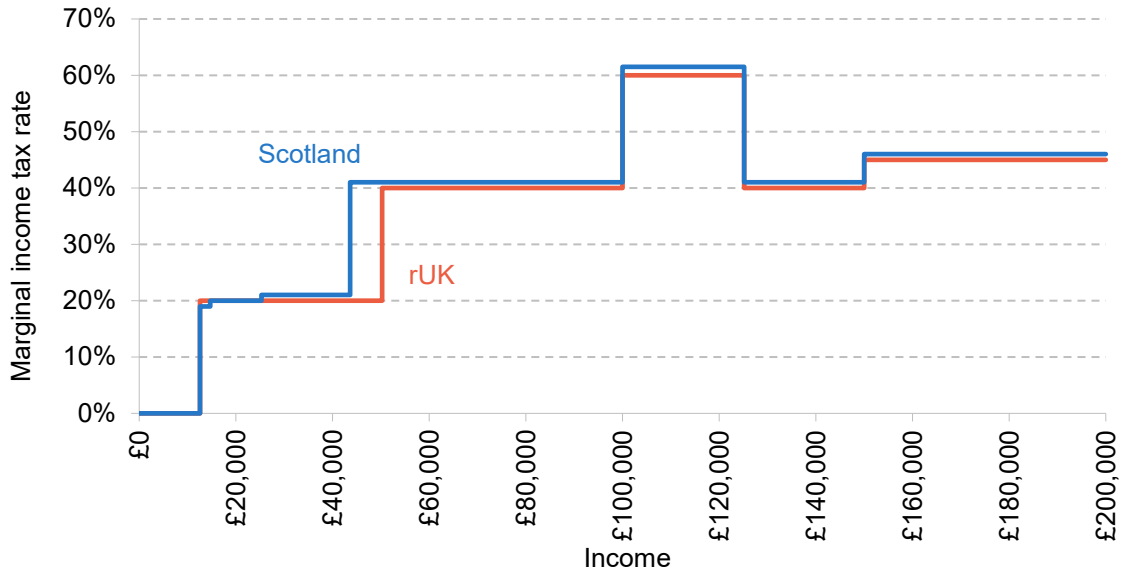
Note: Thresholds assume the individual receives the standard personal allowance. Taxpayers classified according to the highest band in which they have non-savings, non-dividend income: some will have savings or dividend income in a higher band. The 1,995,000 figure for adults classified as below the personal allowance is calculated as the difference between the total number of taxpayers and the total adult (i.e. aged 16+) population of Scotland; the classification is not strictly accurate as the adult population and the taxpayer population can differ for reasons other than having income below £12,570.

Source: Number of taxpayers from table 2 of

<https://www.gov.uk/government/statistics/scottish-income-tax-outturn-statistics-2018-to-2019>.

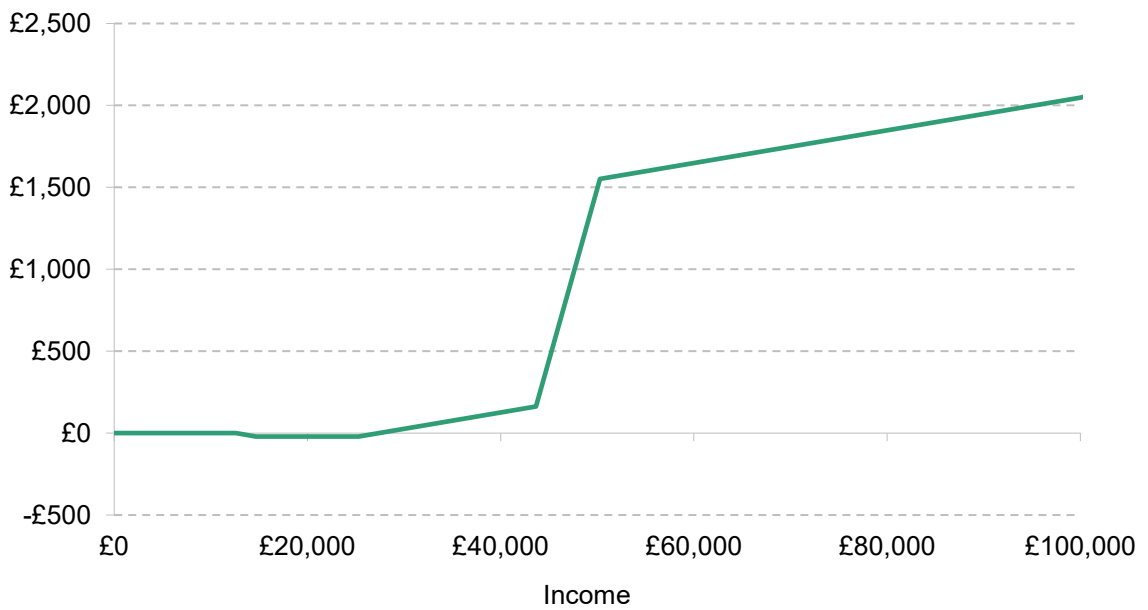
Total adult population from ONS 2018-based principal national population projections, <https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections/datasets/z5zippedpopulationprojectionsdatafiles/scotland>.

Figure 2.1. The income tax schedule in Scotland and the rest of the UK, 2021–22



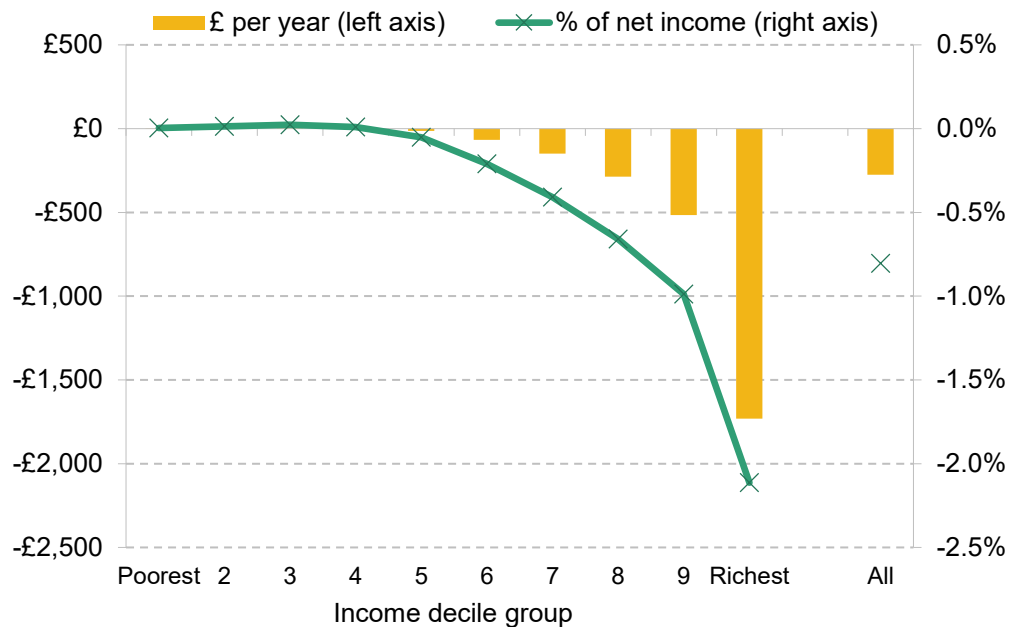
Note: Schedule shown applies to non-savings, non-dividend income. The higher tax rates between £100,000 and £125,140 result from the gradual withdrawal of the personal allowance in that range.

Figure 2.2. Difference in income tax liabilities between Scotland and the rest of the UK, 2021–22



Note: Assumes income is not from savings or dividends.

Figure 2.3. Gains and losses from applying Scottish rather than rUK income tax schedule



Note: Households in Scotland are divided into 10 equal-sized groups based on their net income adjusted for household size using the Modified OECD equivalence scale.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on updated data from the 2018–19 Family Resources Survey.

Figure 2.3 shows the effect of this across the household income distribution in Scotland, with barely perceptible gains on average for the bottom four tenths of the distribution and the top half being significantly worse off than they would be under the rUK tax schedule. Facing the Scottish income tax schedule rather than the rUK one costs the highest-income tenth of households an average of around £1,700 a year, or 2% of their net income.

This income tax schedule raises more revenue for the Scottish Government than mirroring rUK's rates would, and raises it from the higher-income half of households.

However, the corollary of higher and more progressive tax rates is that they slightly weaken overall incentives for Scottish residents to work, and more broadly to generate taxable income. Incentives are marginally stronger for those with lower incomes (who face lower tax rates), but weaker for those with higher incomes. They

may respond by, for example, working less, shifting more income into tax-advantaged forms, hiding more income from the taxman, or moving their (actual or reported) residence out of Scotland. These potential responses are largely the same as those faced by the UK government when setting income tax rates; one difference is that Scottish tax rates do not apply to savings and dividend income (or to capital gains), so increases in Scottish income tax rates inevitably increase the incentive to shift income into those forms – for example, by setting up and working through a company rather than as an employee.

Overall, the Scottish Government estimated that it would raise £456 million more revenue in 2020–21 than if it had used the same income tax schedule as rUK, but that in the absence of behavioural responses that would have been £591 million: responses to the weaker incentives created by the Scottish income tax schedule cost it £135 million, or 23%, of the £591 million ‘mechanical’ yield of the higher income tax rates.⁶

Having a higher-rate threshold that is lower than in rUK is a reasonable way to raise significantly more revenue from better-off taxpayers. But having separate 19%, 20% and 21% rates is an unnecessarily complicated way to make the system more progressive. The rates are so similar, and the 19% band so narrow, that having multiple rates achieves very little except as a political statement. An almost identical distribution of tax payments could be delivered more simply with fewer bands. As a very simple example, removing the 20% rate by extending the 19% starting-rate band up to cover the bottom half of it and extending the 21% intermediate-rate band down to cover the top half would make a negligible difference to anyone’s tax payments (or to Scottish Government revenue) but would

⁶ Source: https://archive2021.parliament.scot/S5_Finance/General%20Documents/Report_on_2020_and_21_Scottish_Budget.pdf. While Scottish Government revenue was £456 million higher than it would have been with rUK tax rates, that does not mean revenue was £456 million higher than it would have been without devolution. Taxable incomes have grown less quickly in Scotland than in rUK; under the devolution settlement, the resulting loss of revenue is borne by the Scottish Government. Revenue forecasts and population projections suggest this will offset all but £117 million of the revenues from the Scottish Government’s higher tax rates (see Phillips (2021)). (Note that Scottish Government (2021b), which projects forward actual population growth between 2018 and 2019, rather than using ONS projections for growth between 2019 and 2020, has estimated that all but £87 million of the higher revenues will be offset.)

mean one fewer tax band. Alternatively, the Scottish Government could have introduced a small zero-rate band above the personal allowance – fulfilling the SNP’s 2016 manifesto pledge to increase the amount of tax-free income to £12,750 (which it has not met) – with the rate increasing directly to 21% above that.⁷ In so far as it made any difference at all, such a policy would be slightly more progressive – as well as simpler – than that adopted by the Scottish Government.

3. Council tax increased and made more progressive, but much-needed reform ducked

Following a nine-year freeze in council tax rates across Scotland from 2007–08 to 2016–17, Scottish local authorities were allowed to increase council tax rates (up to a cap) in the following four years. Although the Scottish Government has funded a freeze in 2021–22, the average Band D rate across Scotland is now 14% higher than it was in 2016–17: an increase averaging 2.6% a year. That is a real-terms increase of 4% over the five years, or 0.8% a year on average.

However, bills for high-value properties have increased more quickly than this. Following the report of the Commission on Local Tax Reform (2015), in 2017 the Scottish Government increased the relative tax rates in the top four bands (which contain just over a quarter of properties), as shown in Table 3.1. A new form of council tax reduction scheme was introduced to exempt low-income families (loosely conceived of as the lower-income half, with income below £321 a week for single people without children or £479 a week for others) living in high-band properties from these increases.

⁷ A 21% basic rate would have broken another manifesto pledge, to freeze the basic rate of income tax at 20%. As it stands, it is debatable whether actual policy – splitting the basic-rate band into three, with 19%, 20% and 21% rates – is consistent with that commitment. Both manifesto commitments could have been met by keeping the basic rate at 20%, introducing a smaller zero-rate band and reducing the higher-rate threshold. Eiser (2021) systematically assesses which of the SNP’s 2016 manifesto commitments on tax have been met and which have not.

Table 3.1. Council tax bands and billing ratios in Scotland

Band	1991 property value	Proportion of dwellings, Sept. 2020	Tax rate relative to Band D:	
			Until 2017	From 2017
A	Up to £27,000	19.8%	67%	67%
B	£27,001 to £35,000	22.8%	78%	78%
C	£35,001 to £45,000	16.2%	89%	89%
D	£45,001 to £58,000	13.7%	100%	100%
E	£58,001 to £80,000	13.7%	122%	131%
F	£80,001 to £106,000	8.1%	144%	163%
G	£106,001 to £212,000	5.2%	167%	196%
H	Above £212,000	0.5%	200%	245%

Source: Number of dwellings in each band from <https://www.gov.scot/publications/council-tax-datasets/>.

There is a logic to these reforms. Band H properties have a (1991) value at least 7.9 times as high as Band A properties, yet before this reform they attracted just 3 times as much tax. The reform increased this to 3.7 times as much tax – still much less than proportional to property value, but closer to it.

The higher tax burden falls on people owning the most valuable properties (or the properties that were most valuable in 1991).⁸ This is a relatively economically efficient way to raise revenue from the better-off: it does not create disincentives to work or to relocate outside Scotland in the way that, say, increasing income tax

⁸ Council tax is legally payable by the occupier, not the owner, of a property, so in the case of rental properties – which are less common at the top end of the market anyway – the additional tax is paid by the tenant, not the landlord. However, economic theory and empirical evidence suggest that when the property tax that tenants must pay increases, the market rent that landlords can charge decreases, so we would expect the rent on high-value properties to fall in response to the tax reform (or perhaps increase less than it otherwise would have), in effect passing most of the burden of the tax rise from tenants to landlords.

does. The main effect on incentives is to slightly reduce the return to building high-value housing in Scotland, since developers will not get as much for selling it now that it comes with a bigger tax bill attached.

However, the 2017 changes ducked the more thoroughgoing reform that council tax desperately needs. While stopping short of detailed policy recommendations – leaving those to politicians – the Commission on Local Tax Reform clearly envisaged much more radical changes than these. It recommended keeping an annual tax on housing and making it more progressive, as the Scottish Government has done (though the options illustrated by the Commission were more radical than that chosen by the Scottish Government); but it also made clear that ‘The substantial political challenge of linking liabilities to up-to-date property values must ... be overcome’. The Commission also described the possibility of a land value tax as ‘promising’, recommending that it be analysed further during the parliamentary term that is now ending, and it recommended the introduction of a local income tax if feasible alongside property taxes, and possibly any of a number of smaller taxes as well.

The case for a land value tax and/or a local income tax is debatable.⁹ But the case for bringing council tax valuations up to date is not.

Like England, but unlike Wales, Scotland still levies council tax based on properties’ values in 1991.¹⁰ That is a problem because not all properties have increased in value at the same rate since then. As a result, two households living in the same local authority in properties that are now equally valuable can find themselves paying tax bills hundreds of pounds apart, just because their properties were worth different amounts in 1991. And since Scottish Government funding to local authorities depends on these outdated valuations, councils in areas where values have gone up relatively little have to charge higher taxes as a share of current values than councils in areas where values have gone up a lot. Such arbitrary variations in tax bills for similar households are unfair and indefensible.

⁹ See Amin Smith, Harris and Phillips (2019) for a discussion of the pros and cons of allowing English councils to set a local income tax *in addition* to council tax.

¹⁰ Northern Ireland operates a different system, domestic rates, but also uses more recent (specifically, 2005) valuations.

Bringing council tax up to date would be politically challenging, as it would create losers as well as winners. But there is no principled case for maintaining the status quo. The longer it continues, the worse the inequities become and the bigger the gains and losses involved in correcting them. It is ludicrous to imagine that in another 30 years' time, in 2051, we might still be taxing people based on what their properties were worth in 1991. At some point, the nettle has to be grasped, and it is an indictment of the current government – like its predecessors and its Westminster counterpart – that it has failed to do so. Having had a review of local taxation and introduced reforms, it is inexcusable to continue using property valuations which are now 30 years old.¹¹

Comparing council tax rates in Scotland with those in Wales and England is not straightforward. The average Band D rate is lowest in Scotland: £1,308 in 2021–22, compared with £1,731 in Wales and £1,898 in England. But a Band D property in Scotland is not the same as a Band D property in Wales or England. Wales's council tax bands reflect the outcome of the revaluation that took effect there in 2005. And although council tax in England is also still based on 1991 values, the band cut-offs there have always been different from those in Scotland. For example, a Band D property in Scotland is one that was worth between £45,001 and £58,000 in 1991, whereas a Band D property in England was worth £68,001–£88,000.

Figure 3.1 shows how council tax bills vary by 1991 property value in Scotland and England,¹² assuming the average Band D rate across local authorities in the respective nations and taking into account the different band cut-offs in each nation as well as the higher tax ratios for Bands E to H now in place in Scotland.

For a local authority setting the Scottish average Band D rate, properties with a 1991 value of £58,000 or less – that is, in Bands A to D in Scotland (73% of Scottish properties) attract less council tax than they would if the English system applied (with the English average Band D rate). For higher-value properties, the pattern varies, though for the very highest-value properties council tax is again unambiguously lower in Scotland: the lower average Band D rate in Scotland more

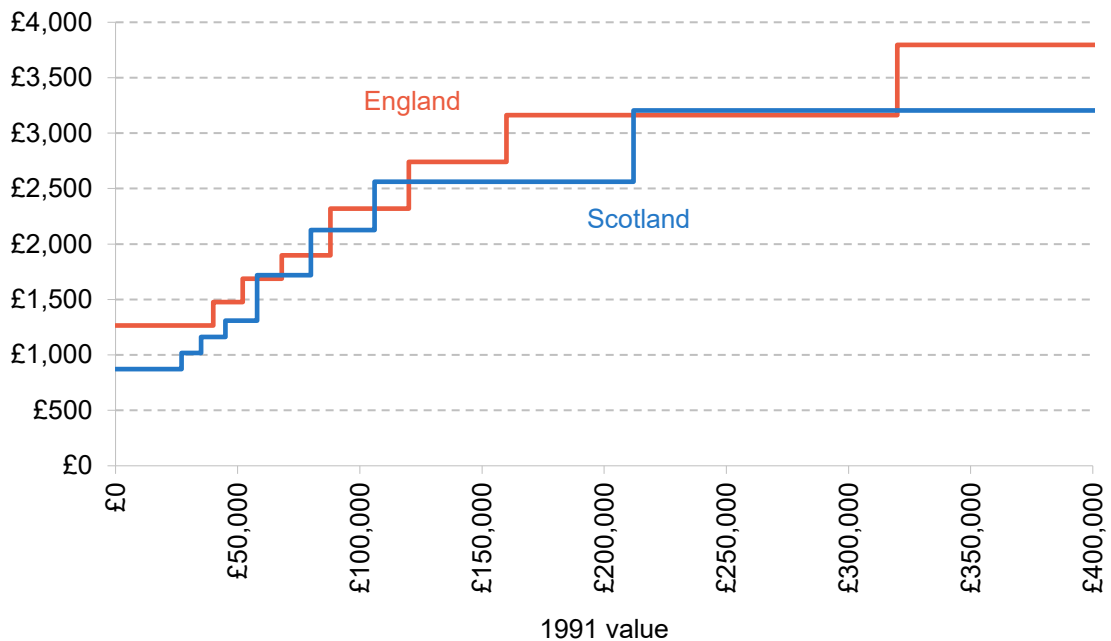
¹¹ Council tax has other problems as well, such as the inefficient allocation of housing caused by the structure of the single-person discount. Adam et al. (2020a, 2020b) provide a detailed analysis and quantification of options for council tax reform in England and Wales. While the specific numbers will differ in Scotland, the patterns will be qualitatively similar and the policy issues the same.

¹² Wales cannot be compared in the same way because its council tax bands are based on 2003, not 1991, property values.

than offsets the effect of increasing the multiple of the Band D rate charged in Band H.

Property prices have not grown at the same rates in England and Scotland since 1991, so this does not necessarily paint an accurate picture of how Scottish and English council tax liabilities compare for a property with the same *current* value. However, it will still be true that council tax is lower in Scotland than England for both the lowest-value and the highest-value properties.

Figure 3.1. Council tax due in a local authority setting the average Band D rate in Scotland and England, 2021–22



The council tax reduction scheme

As well as applying lower council tax rates to low-value properties, Scotland also provides more generous discounts for those with low income and savings. This has been true since 2013, when the UK-wide council tax benefit was abolished and responsibility for providing help for the less well-off was devolved to English local authorities and the Scottish and Welsh governments: the Scottish and Welsh governments both decided to maintain the existing system across their respective nations, while most English local authorities reduced the generosity of their schemes for working-age claimants in the face of reduced funding for them from the UK government. The gap widened in subsequent years as English local

authorities continued to make further cuts.¹³ But while the pre-2013 system has largely been maintained in Scotland (and Wales), there have been some changes.

Historically – when council tax benefit was a UK-wide scheme – the level of family income at which support began to be withdrawn was pegged to the level of other UK benefits. Since responsibility for helping low-income families with their council tax was devolved, the Scottish Government (like the Welsh Government and most English local authorities) has chosen to maintain that link to benefit rates. As a result, the UK government’s real-terms reduction in benefit rates – four years of freezes and three years of 1% cash-terms increases – was mirrored in a harsher means-test of Scotland’s council tax reduction scheme, reducing support for low-income (though not the very lowest-income) families.

In other respects, however, the Scottish Government has made its council tax reduction scheme (CTRS) slightly more generous: most notably, in 2017 it increased the per-child allowance in the level of income that families can receive before support is withdrawn. As noted above, a new variant of the CTRS was also introduced in 2017 alongside the increases in tax rates for Bands E to H, essentially exempting low-income families who live in such properties (and were not already protected by the existing council tax reduction scheme) from the tax rise they would otherwise have faced.

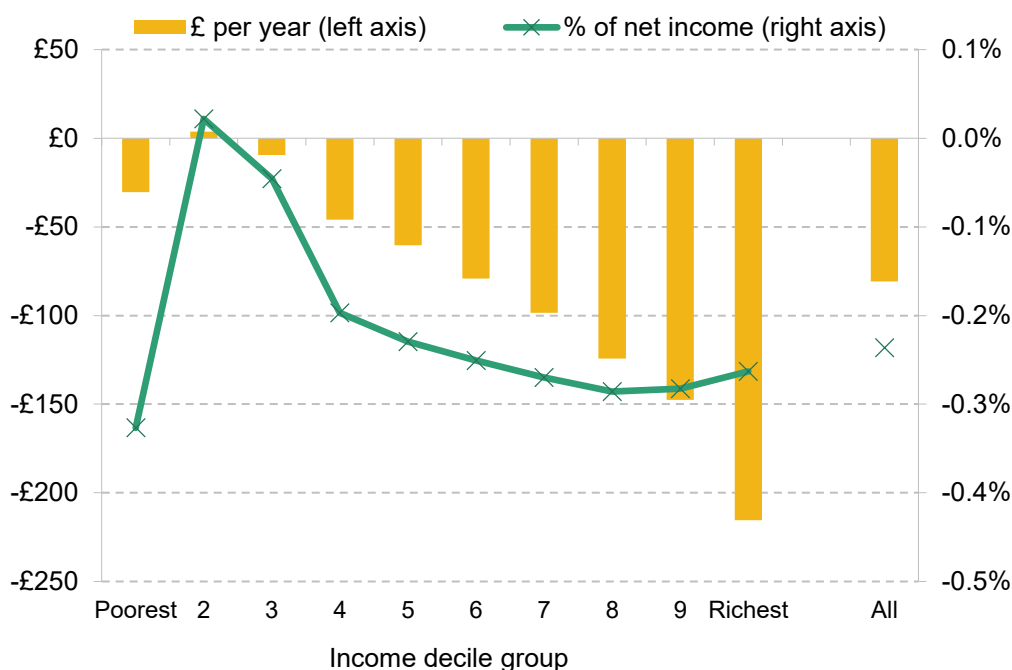
Council tax support for low-income families in Scotland has therefore become slightly more generous for some, and slightly less generous for others – in contrast to England, where it now varies across local authorities but has become significantly less generous on average.

Overall – taking into account changes in Band D rates, increases for higher bands, changes to CTRS and changes to the composition of the housing stock – the average council tax bill in Scotland is about 10% higher in real terms than it was in 2016–17, a real increase of just under 2% a year. This stands in stark contrast to the nine years of freezes that preceded this parliament, which represented a 2%-a-year real reduction (a cumulative 17% over the nine years). But the real-terms increase

¹³ See Adam, Joyce and Pope (2019) for an analysis of the cuts to support in England and their consequences.

since 2016–17 has been faster in England: almost 3% a year, on average, or 16% in total.

Figure 3.2. Gains and losses in 2021–22 from real-terms changes to council tax and council tax reduction scheme in Scotland since 2016



Note: Chart shows the direct effect on occupiers, ignoring any knock-on effects on rents which might pass some of the burden of tax increases from tenants to landlords. Households in Scotland are divided into 10 equal-sized groups based on their net income adjusted for household size using the Modified OECD equivalence scale.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on updated data from the 2018–19 Family Resources Survey.

Figure 3.2 shows the direct effects across the income distribution of the real-terms changes to council tax and CTRS introduced in Scotland during the current parliament. Note that it shows the direct effect on occupiers, ignoring the likely knock-on effects on rents discussed above which might pass some of the burden of tax increases from tenants to landlords. On average, households have lost about £80 a year, ¼% of their average income. But the losses are larger towards the top of the income distribution than the bottom, both because high-income households are more likely to live in high-band properties, which have seen the biggest tax increase, and because low-income households are more likely to be protected from

tax rises by the CTRS – which, moreover, has become more generous for many. The striking average losses for the lowest-income tenth – sizeable as a share of their income, though modest in cash terms – arise because some of those reporting very low current incomes nevertheless have significant wealth (excluding housing and pensions), which disqualifies them from the CTRS. Their low current income often does not reflect their lifetime circumstances; they are also more likely to live in higher-band properties and therefore lose more from the council tax rises introduced by the Scottish Government and Scottish local authorities.¹⁴ Whether such people should be regarded as ‘poor’ is debatable.

4. Business rates reductions make it increasingly complicated

Business rates are a tax paid by firms on the estimated rental value of the property they occupy.

Temporary business rates reliefs (and associated grants) have been an important part of the Scottish Government’s economic response to the COVID-19 crisis. The details of this support continue to evolve as the crisis continues: the 100% relief provided for retail, hospitality, leisure and airports has now been extended until at least the end of 2021–22 – longer than has been announced (so far) for England – and in March the Scottish Government announced a new tranche of grants for retail, hospitality and leisure businesses.¹⁵ Business rates reliefs have been a well-targeted component of the government response in Scotland and across the UK, helping firms with a fixed cost that would not automatically fall when business dried up (unlike corporation tax or VAT liabilities, for example) and would therefore cause problems for many businesses that would otherwise still be viable in the long term.

Even aside from these temporary measures, business rates in Scotland have been significantly – though not fundamentally – reformed over the course of the current parliament, largely in line with the recommendations of the Barclay Review (2017).

¹⁴ There is also evidence that some apparently very low incomes represent under-recording in the survey data. See Brewer et al. (2009) and Brewer, Etheridge and O’Dea (2017) for evidence and discussion of the phenomenon that many of the lowest-income households in surveys have high living standards by other measures.

¹⁵ See <https://www.gov.scot/news/supporting-businesses-through-the-pandemic/>.

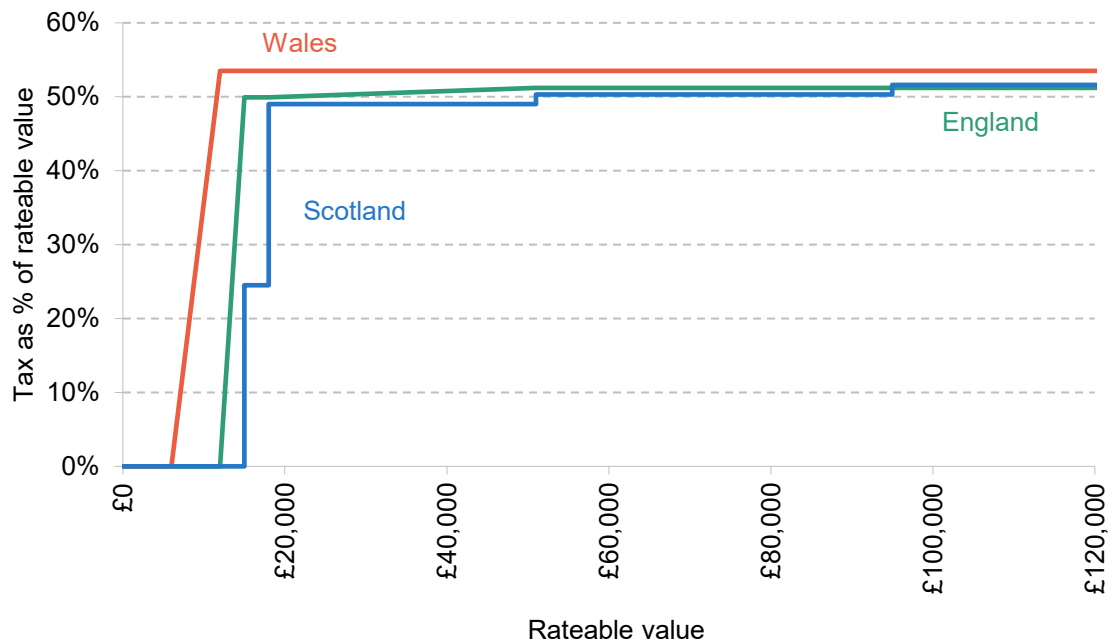
The changes include some welcome improvements to the way business rates work, including uprating them with CPI inflation each year rather than the discredited RPI measure and reforms to relate business rates bills more closely to up-to-date values in future by moving to more frequent (three-yearly) revaluations and shortening the gap from the date of valuation to the date the new valuations start to be used.

There has also been a change in the way that business rates bills vary with the estimated rental value of the property. While the Barclay Review recommended reducing the business rates supplement that applies to high-value properties, to bring the tax rate for them into line with England's, the Scottish Government decided to reduce the rate for some high-value properties but not the very highest-value: in other words, creating a new intermediate rate in between the standard rate and the large-business rate.¹⁶ Scotland already had a more generous system of relief for low-value properties than England and Wales, and made it even more generous in 2017. And 2021–22 saw a reduction in tax rates for all properties in Scotland, with the standard rate (which applies to properties with a 2015 market rental value between £18,000 and £51,000) falling from 49.8% to 49.0% rather than rising with inflation as it normally does.

Figure 4.1 shows the business rates schedules in Scotland, Wales and England, excluding the temporary COVID-related reliefs that are currently in place. It shows that Scotland has the lowest business rates in Great Britain except for properties with an estimated 2015 market rental value of more than £95,000 a year (a small proportion of properties, though they account for a much larger share of business rates revenue). Those highest-value properties attract tax of 51.6% of their rental value in Scotland, slightly higher than the 51.2% rate in England but still lower than the 53.5% rate in Wales.

¹⁶ See Eiser (2021) for more discussion.

Figure 4.1. Business rates schedules, 2021–22, ignoring temporary COVID-related reliefs



Note: Assumes a business occupying a single property. Schedule for England is that which applies outside London.

The lower business rates that apply to most premises in Scotland have been lauded as making Scotland a more competitive place to do business.¹⁷ But economic theory and the (limited) empirical evidence available suggest that, in the long run, business rates are likely to be mostly reflected in the rents charged on properties. Lower business rates are therefore – at least in the long run – likely to be a boon to property owners, who can charge higher rents than the market would bear if business rates were at English or Welsh levels – and who have suffered from a long-term decline in their fortunes as developments such as the rise of online retail have reduced the value of commercial property. But it is not clear that lower business rates will do much in the long term to reduce the overall cost of business premises to the firms occupying them, and therefore do much to make doing business in Scotland more attractive.

¹⁷ See Eiser (2021).

The main respect in which lower business rates make Scotland more competitive is that they strengthen the incentive to develop business property in Scotland by raising the price that properties will fetch. That incentive has been further enhanced by the introduction of the £50-million-a-year Business Growth Accelerator Relief, a 12-month business rates exemption for newly built premises or improvements to existing premises, which is quite well targeted to encourage property development.¹⁸ However, the effect of business rates on discouraging the development and use of business property could be removed almost completely without the revenue cost that these tax cuts entail, by replacing business rates with a land value tax, levied on the value of land excluding any buildings on it.¹⁹ The Barclay Review, like the Commission on Local Tax Reform before it, recommended that more work should be done to assess land values so that the consequences of such a reform could be better understood. As yet, there is no sign of the Scottish Government (or indeed the UK government) doing this.

Figure 4.1 highlights that relief for small businesses in Scotland is not only more generous than in England and Wales but is also structured differently, with a series of discrete steps up in liability when certain thresholds are crossed. Such steps are undesirable: they mean that, for example, a property with a rateable value of £18,001 attracts twice as much business rates as a property with a rateable value of £18,000 – an extra £4,410 tax for a property that costs £1 more to rent. That is clearly an absurd structure for any tax. This is in noticeable contrast to the way that Scotland led the UK in removing precisely such an anomaly elsewhere in the property tax system, when it introduced land and buildings transaction tax (which has no such jumps) in place of stamp duty land tax (which did at the time).

The tax rate schedule shown in Figure 4.1 is surprisingly complicated, particularly when the underlying rationale for varying the tax rate by property value is unclear.²⁰ The introduction of an intermediate rate adds further to the complexity of

¹⁸ Cost estimate from table B.1 of Scottish Fiscal Commission (2018).

¹⁹ Mirrlees et al. (2011) discuss the arguments for such a reform and the main practical obstacle, the need to ascertain the value of land excluding buildings.

²⁰ It is tempting to think of levying higher tax rates on high-value properties as akin to levying higher tax rates on high-income individuals, but the analogy is flawed. The people who ultimately bear the burden of a tax on business property – a combination of the tax-paying firms' owners, employees, customers, suppliers or (most likely) landlords – are not necessarily any better off for high-value properties than for low-value properties. Taxing high-value properties does not necessarily affect better-off people more than taxing low-value properties.

the rate schedule. And the rate schedule is not the only aspect of business rates that has become more complicated.

Business Growth Accelerator Relief is just one of a number of new or expanded business rates reliefs introduced during the current parliament. These include reliefs for premises used for district heating networks, nurseries, renewable power generation, fibre broadband infrastructure and reverse vending machines – on top of an already long list of reliefs. Whatever the rights and wrongs of each relief individually, collectively they add to the complexity of the system. Their proliferation raises the question of whether business rates reliefs are really the best tool to achieve the Scottish Government’s social and environmental objectives in all these cases. And when a tax has so many carve-outs, it raises the question of whether the underlying design of the tax reflects what the government really wants to achieve or whether more fundamental reform is needed.

5. Land and buildings transaction tax more progressive than England’s – but should be abolished

When tax on property transactions was devolved to Scotland in 2015, the Scottish Government designed its new land and buildings transaction tax (LBTT) to work in a more sensible way than the stamp duty land tax (SDLT) it replaced, removing the sharp jumps in liability at thresholds that had hitherto characterised SDLT. This was a clear improvement: it was absurd to charge thousands of pounds (in the most extreme case, £40,000) more tax on a purchase just above a threshold than on a purchase just below it, and doing so distorted the housing market (Best and Kleven, 2018; Borbely, 2020). At the same time, LBTT was made more progressive than SDLT had been, with tax rates reduced for lower-value transactions and increased for higher-value transactions. The UK government followed where Scotland led, removing jumps in liability from the SDLT schedule and making it more progressive. When SDLT was devolved to Wales in 2018, the land transaction tax (LTT) created by the Welsh Government followed the same pattern, and Wales also made its new tax more progressive, albeit less progressive than Scotland’s LBTT.

Table 5.1. Rates and thresholds of LBTT for residential property, 2021–22

Band	Rate	Proportion of transactions, 2019–20
£0 – £145,000 ^a	0%	45%
£145,000 ^a – £250,000	2%	34%
£250,000 – £325,000	5%	11%
£325,000 – £750,000	10%	9%
£750,000+	12%	1%

^a £175,000 for first-time buyers.

Note: Rates apply to the part of the value in each band, not to the whole value if the transaction is in that band. Additional 4% of the full purchase price payable on transactions above £40,000 if the buyer owns another residential property.

Source: Proportions of transactions calculated by the authors from Revenue Scotland, *Land and Buildings Transaction Tax Statistics: February 2021*, <https://www.revenue.scot/about-us/publications/statistics/lbtt-statistics>.

Since LBTT was introduced, the thresholds have been frozen and there have been no permanent changes to the main rates for residential property, which are shown in Table 5.1. But there have been a number of other reforms in the current parliament:

- In June 2018, the Scottish Government introduced a new relief for first-time buyers, following the UK government's doing so for England and Northern Ireland a few months earlier (Wales has no such relief). The Scottish relief increases the threshold from £145,000 to £175,000 for first-time buyers, a maximum tax reduction of £600 – much less generous than the relief in England and Northern Ireland, which can deliver a tax saving of up to £5,000. The Scottish Fiscal Commission estimates that the relief costs the Scottish Government less than £10 million a year.²¹

²¹ Source: Table B.1 of Scottish Fiscal Commission (2018).

- In January 2019, the Scottish Government increased the additional dwelling supplement, which (since April 2016) must be paid if the buyer already has another residential property (e.g. on second or rental homes), from 3% to 4%. This increase is estimated to raise around £25 million a year.²² The Welsh Government has recently followed suit, but the rate in England remains 3%.
- In response to the COVID crisis, the Scottish Government temporarily increased the LBTT threshold from £145,000 (or £175,000 for first-time buyers) to £250,000 between July 2020 and March 2021: a tax cut of up to £2,100 at a one-off cost of about £50 million.²³ Wales introduced a broadly similar policy, though lasting until July 2021 rather than March 2021. But the giveaway in England and Northern Ireland is both significantly more generous and longer-lasting: increasing the threshold from £125,000 to £500,000 (a tax cut of up to £15,000) up to July 2021 and to £250,000 (a tax cut of up to £2,500) up to September 2021.

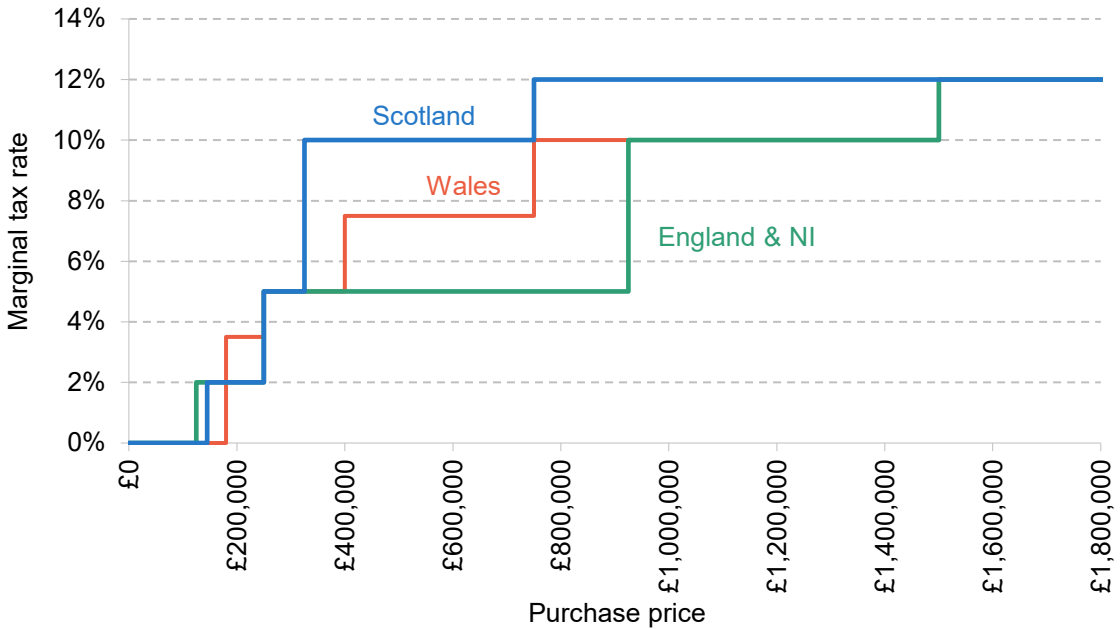
Putting aside the temporary COVID measures and the special regimes for first-time buyers and additional properties, Figure 5.1 compares the current marginal rate schedule and Figure 5.2 compares the tax due as a percentage of purchase price in Scotland with those in the other nations of the UK.

LBTT in Scotland is more progressive than SDLT in England and Northern Ireland. Its higher tax-free threshold – £145,000 rather than £125,000 – means that Scotland charges £400 less tax than England and Northern Ireland on residential property transactions between £145,000 and £325,000. As with income tax, the majority either pay no tax or benefit from lower rates than in rUK, but the size of these gains is dwarfed by the size of the losses for the minority at the top, caused by higher rates' kicking in from a lower level. For transactions above £333,000 – about one in ten purchases in Scotland – tax in Scotland is the highest tax in the UK: for a £750,000 purchase, Scotland charges £48,350, compared with £27,500 (£20,850 less) in England and Northern Ireland and £36,200 (£12,150 less) in Wales.

²² Source: Table B.1 of Scottish Fiscal Commission (2019).

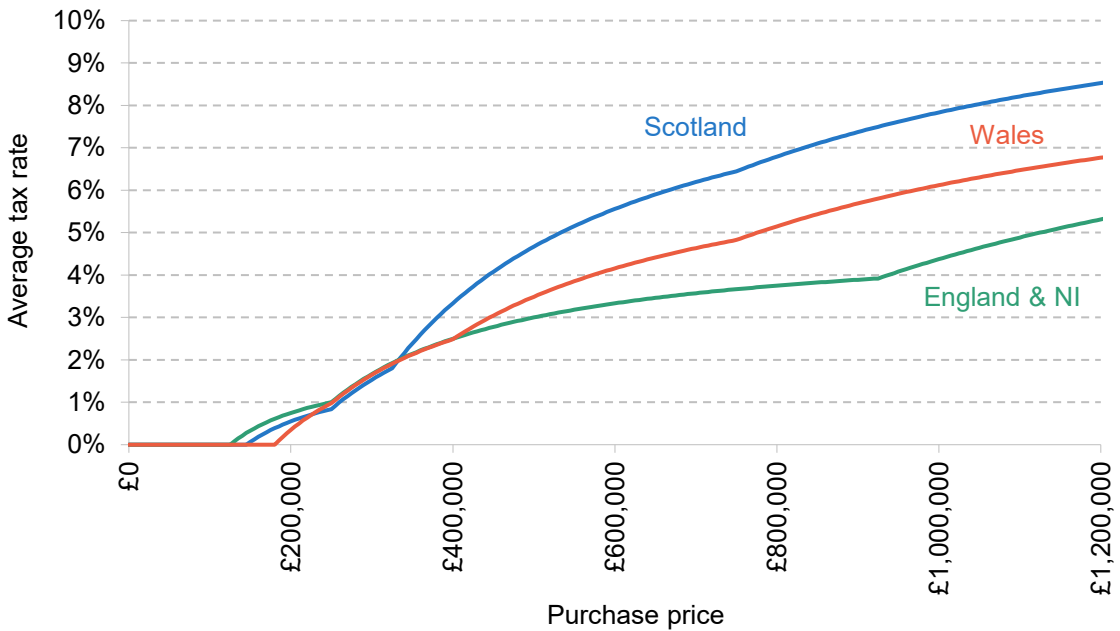
²³ Source: Figure B.1 of Scottish Fiscal Commission (2021).

Figure 5.1. Residential property transaction tax schedules, 2021–22, ignoring temporary COVID-related reliefs



Note: Rates shown apply where the buyer is not a first-time buyer and does not have another residential property.

Figure 5.2. Average tax rates on residential property transactions, 2021–22, ignoring temporary COVID-related reliefs



Note: Rates shown apply where the buyer is not a first-time buyer and does not have another residential property.

While the main rates of LBTT for residential property are the same now as they were at the time of the last Scottish Parliament elections, LBTT rates for non-residential property changed in January 2019. Table 5.2 shows the rates and bands before and after the reform and the proportion of transactions located in each band. The effect of the reform was to reduce the tax payable on transactions between £150,000 and £350,000, and to increase the tax on transactions above that level. Only a third of transactions are above £350,000, but they account for 98% of the revenue from non-residential transactions, so this was a net tax rise, forecast to raise around £15 million a year.²⁴ The reform follows the now-familiar pattern of reducing tax liabilities at the bottom and increasing them at the top – though, as with business rates, we should remember that taxing high-value business properties more and low-value business properties less does not necessarily translate into redistributing from better-off to worse-off households.

Table 5.2. Rates and thresholds of LBTT for non-residential property, 2021–22

Band	Rate before 2019	Rate since 2019	Proportion of transactions, 2019–20
£0 – £150,000	0%	0%	47%
£150,000 – £250,000	3%	1%	14%
£250,000 – £350,000	3%	5%	7%
£350,000+	4.5%	5%	32%

Note: Rates apply to the part of the value in each band, not to the whole value if the transaction is in that band.

Source: Proportions of transactions calculated by the authors from Revenue Scotland, *Land and Buildings Transaction Tax Statistics: February 2021*, <https://www.revenue.scot/about-us/publications/statistics/lbtt-statistics>.

²⁴ Source: Table B.1 of Scottish Fiscal Commission (2019).

Figure 5.3. Non-residential property transaction tax schedules, 2021–22

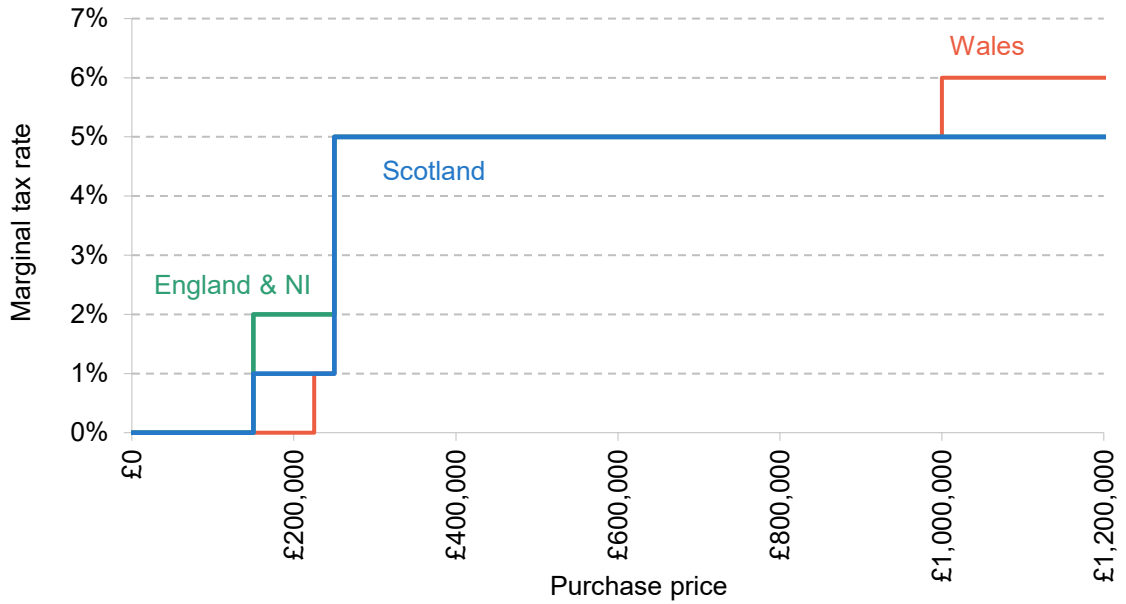


Figure 5.4. Average tax rates on non-residential property transactions, 2021–22

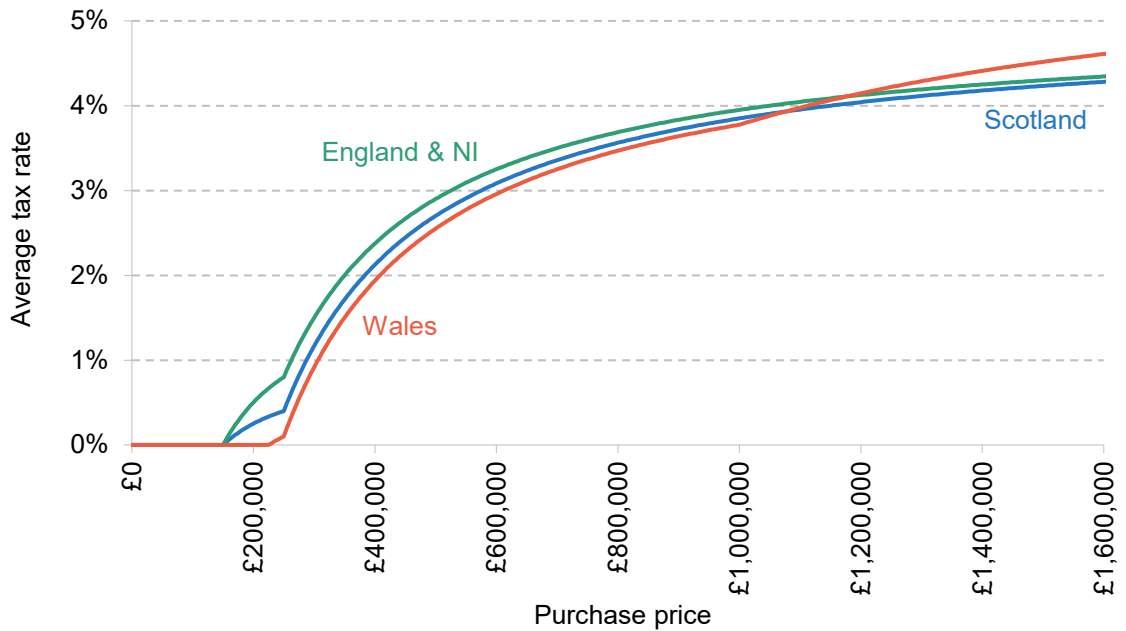


Figure 5.3 compares the current marginal rate schedule and Figure 5.4 compares the tax due as a percentage of purchase price in Scotland with those in the other nations of the UK.

LBTT for non-residential property transactions in Scotland is slightly higher than the equivalent tax in Wales (except for transactions above £1.075 million) and slightly lower than that in England and Northern Ireland. But the differences are small: for any non-residential transaction between £250,000 and £1 million, Scotland charges £750 more than Wales and £1,000 less than England and Northern Ireland.

As with council tax and business rates, the major reforms needed to LBTT have been ducked.

Removing the jumps in liability when introducing LBTT was a clear improvement, but a relatively minor one. It did not address the more fundamental problem that taxing property transactions is an exceptionally damaging way to raise revenue. It discourages mutually beneficial transactions, so properties are not owned by the people who value them most. In concrete terms: LBTT discourages people from downsizing, upsizing, or moving to a different location to take a job or enjoy their retirement. That misallocation of property makes everyone worse off.²⁵

As recommended by, among others, the Mirrlees Review of the tax system (Mirrlees et al., 2011) a decade ago, the Scottish Government and its counterparts elsewhere in the UK should reduce – or preferably abolish – the tax on property transactions, and make up the revenue by raising more from a reformed council tax and business rates. This would be fairer and more efficient. Making up the revenue through other property taxes would prevent the tax cut bidding up overall property prices and therefore being a giveaway to existing property owners. Another consequence would be to decentralise more of Scotland’s revenue-raising to local authorities.

²⁵ Borbely (2020) finds that making LBTT more progressive somewhat ameliorated the problem, as the tax cut for lower-value properties significantly increased the number of transactions whereas the tax rise for higher-value properties appeared to have little effect on dampening the market (except in the very highest band). But the high overall responsiveness found confirms the damaging effects of taxing transactions at all.

6. What about further tax devolution?

While it says little about plans to use existing tax powers, the Scottish Government's Medium-Term Financial Strategy (Scottish Government, 2021a) does highlight a number of priorities for further tax devolution. These include National Insurance contributions (NICs), capital gains tax, and further powers over income tax, as well as devolving (rather than assigning revenues from) VAT.

In assessing these options, it is first worth noting the general pros and cons of tax devolution. The possible advantages include:

- tailoring tax policy to preferences and circumstances in Scotland, which may differ from those elsewhere in the UK;
- the ability to integrate the newly devolved taxes better with tax and other policies that are already devolved;
- stronger financial incentives for the Scottish Government to boost the economy as a result of the additional revenue retained.

The potential drawbacks include:

- higher administration and compliance costs when tax rates and rules differ in different parts of the UK;
- the potential for taxpayers to respond to differences in tax policy by shifting the actual or reported location of their taxable activities, in turn incentivising tax competition between different parts of the UK;
- risk to Scottish Government finances as a result of greater exposure to relative rises and falls in economic performance when more of the Scottish Government's funding depends on devolved tax revenues.²⁶

The balance between these pros and cons depends both on the specific taxes in question and on the powers already devolved to the Scottish Government. Given this, what can we say about the specific suggestions set out in the Medium-Term Financial Strategy?

²⁶ A fuller discussion of the pros and cons of tax devolution and how these apply to different taxes can be found in Amin Smith, Harris and Phillips (2019), albeit in the context of devolution to LAs and regions within England, rather than to Scotland.

- Devolving powers to set rates and bands for income tax on savings and dividend income would allow the Scottish Government to apply any changes in tax bands and rates to all taxable income. Doing this would reduce taxpayers' ability to avoid the recent increases in Scottish income tax rates by setting up a company and receiving their income in the form of dividends rather than earnings. On the other hand, the ability of company owners to retain income within their companies – potentially for years – rather than pay it out immediately as dividends would expose the Scottish Government to another potential avenue for tax avoidance that it does not currently face.²⁷
- Devolving power over NICs would allow the Scottish Government to, for example, align the NICs upper earnings limit with the Scottish income tax higher-rate threshold. This would simplify the overall tax rate schedule and reduce the combined income tax and employee NICs rate of 53% that currently applies on earnings between £43,662 and £50,270 (for someone whose taxable income comes entirely from stable employment income) to 43%, the rate that currently applies above £50,270. But this would mean forgoing close to half of the revenue the Scottish Government currently receives from its lower higher-rate income tax threshold. And a similar outcome – although one that might require careful explanation to taxpayers – could be achieved using the Scottish Government's existing powers by setting a 31% income tax rate between the Scottish and UK higher-rate thresholds.
- Depending on the scope of powers devolved on the rates and base of income tax, NICs and capital gains tax, the Scottish Government might be able to make more fundamental changes to how different forms of income are taxed. For example, it might be possible to equalise overall tax rates across different forms of income (employment, self-employment, dividends, capital gains) while also reducing disincentives to save and invest. This would result in both a more efficient tax system – with less distortion to taxpayer behaviour – and a fairer tax system – by removing many of the arbitrary (and large) differences in tax rates faced by people receiving their income in different forms.²⁸ However, such reforms would create many losers as well as winners, and this may discourage the Scottish Government from pursuing reform (as it has perhaps

²⁷ Browne and Phillips, 2017; Miller, Pope and Smith, 2019.

²⁸ See Adam and Miller (2021) for a discussion of the distortions and inequities, and approaches to addressing them.

discouraged the UK government). It has so far chosen not to pursue radical reform in the name of efficiency and fairness in the sphere of property taxation, where it already has the powers to improve the system significantly.

- Devolving VAT to the Scottish Government would require major changes to the operation of the tax, raising administration and compliance costs. It is therefore less suitable for devolution than the aforementioned taxes, although if Scottish preferences over VAT rates and policies differ significantly from preferences in the rest of the UK, it could still be considered.
 - Part of the challenge in devolving VAT would be due to the difficulty of apportioning value added between different activities conducted by a single business (such as their warehouses, shops, headquarters, websites and support operations) that has operations in both Scotland and the rest of the UK. But it would also reflect the way VAT works: it is charged on sales, but businesses can deduct the VAT they have paid on their inputs. Devolved VAT could therefore mean businesses' not only having to charge different VAT rates in Scotland and the rest of the UK, but having to record where their input purchases came from, as different amounts of input VAT would be deductible based on this. Alternatively, borders between Scotland and the rest of the UK could be treated like international borders for the purpose of VAT: businesses 'exporting' to/from Scotland would charge a 0% rate on their 'exports' to other businesses. This would avoid the need for businesses elsewhere in the UK to keep track of Scottish rates of VAT (anything 'imported' from Scotland would be zero-rated), and vice versa. But businesses would have to keep track of whether their customers were VAT-registered businesses and, if so, where they were based, in order to work out whether VAT should be charged or zero-rating applied in the first place, which would also entail costs and potentially be more open to fraud.²⁹
 - Many of the same administration and compliance costs would arise even without devolving powers over tax policy, if VAT revenue were to be apportioned properly between Scotland and the rest of the UK. To avoid

²⁹ The VAT tax base – i.e. sales to final consumers – is also somewhat mobile, especially over small distances. If VAT rates are lower on one side of the Scottish border for at least some goods and services, one might expect cross-border shopping in response.

this, the Scottish and UK governments have instead been trying to use a range of existing data – including a household survey which samples around 800 households in Scotland and 4,700 in the rest of the UK – to apportion revenues between Scotland and the rest of the UK. However, the statistical ‘noise’ inherent in such an approach could swamp the economic ‘signal’ that VAT revenue assignment is meant to provide. It may therefore be worth considering either collecting additional data on household expenditure or business sales, or shelving plans for VAT assignment.

The devolution of the remainder of income tax, NICs, capital gains tax and VAT would more than double the amount of tax devolved to the Scottish Government: in 2019–20, these taxes are forecast to have raised £24.2 billion in Scotland, compared with £17.7 billion for existing devolved taxes. Whether the UK government would be willing to devolve such significant additional revenues and powers, especially under the existing approach to devolution – where the UK government, in effect, compensates the Scottish Government for any pre-existing shortfall in revenues relative to the rest of the UK – is unclear.³⁰

7. New benefits and benefit top-ups support poorer households

In recent years, the Scottish Government has used newly devolved powers to introduce a number of new benefits and to top up existing UK-wide benefits, focusing on low-income families with children, low-income social housing tenants, and those caring for people with disabilities. This is in the context of a set of targets for reducing child poverty – unanimously agreed in the Scottish Parliament – most

³⁰ In the extreme, where all taxes and spending were devolved to the Scottish Government, this approach (termed the ‘no detriment’ approach as it involves no gain or loss to the Scottish Government at the point of devolution) would mean making explicit the implicit fiscal transfers that Scotland is currently in receipt of: in addition to keeping its own taxes, the Scottish Government would receive a ‘top-up’ (potentially to cover its share of UK-wide spending such as defence, overseas aid and debt interest).

notably to reduce the proportion of children in Scotland living in relative poverty from 24% in 2019–20 to 18% or less by 2023–24 and 10% or less by 2030–31.³¹

The permanent changes to benefit entitlements include:

- Topping up the housing benefit (or housing element of universal credit) of social sector tenants deemed by the UK government to be under-occupying their property and subject to the ‘under-occupation penalty’ (or ‘bedroom tax’). This top-up has been in place since 2013–14, when the housing benefit cuts were made by the UK government, and costs the Scottish Government approximately £50 million a year.³² The ‘bedroom tax’ accounts for only a small fraction of the welfare cuts introduced by UK governments since 2010, but has attracted much more attention and antipathy than that might suggest. The beneficiaries of eliminating it are typically low-income families without children living in larger social properties, which have more bedrooms than the family is assessed to need. The policy means that social sector tenants in Scotland are treated more favourably than private sector tenants, whose entitlements are based on an assessment of how many bedrooms they need – though tenants in social housing will often have less control over the size of property they occupy, so it is arguably harsher to penalise them for occupying a (supposedly) unnecessarily large property.
- Providing a supplement to carer’s allowance, a UK government benefit for those caring full-time for someone with a disability (and not earning more than £128 per week). The supplement was introduced in 2018–19 and currently amounts to £8.90 per week for most recipients (paid in six-monthly instalments of £231.40). This cost the Scottish Government £37 million in 2019–20, with around 80,000 people receiving each six-monthly payment.³³ In addition, recipients aged 16–18 are entitled to an additional yearly payment of £308.15 (equivalent to about £5.90 per week). And the Scottish Government has

³¹ Relative poverty is defined as having a net household income (adjusted for household size and composition) below 60% of the UK median.

³² Source: <https://www.gov.scot/policies/social-security/support-with-housing-costs/#discretionary-housing-payment>.

³³ Source: <https://statistics.gov.scot/resource?uri=http%3A%2F%2Fstatistics.gov.scot%2Fdef%2Fconcept%2Ffolders%2Fthemes%2Feconomic-activity-benefits-and-tax-credits>.

pledged to increase payments for families caring for more than one disabled child in the coming parliamentary term.

- Best Start grants, available to families on means-tested benefits such as universal credit and its predecessors.
 - Pregnancy and baby grants were introduced in December 2018 in place of the UK government's Sure Start maternity grant. These are one-off payments made shortly before or after a baby is born, and are currently £606 for a first child and £303 for subsequent children. This is more generous than the £500 provided for only first children in the rest of the UK, and the means test is also more generous in Scotland.
 - Early-learning and school-age grants are one-off grants of £252.50 paid when (roughly speaking) a child is aged 2–3½ and 4½–6 years old, respectively. There is no UK government equivalent of these grants, which started in Spring/Summer 2019.
- The Best Start Foods card, introduced in August 2019, which provides families on means-tested benefits and earning below set limits with vouchers to buy certain healthy foods. These are worth £17 every four weeks during pregnancy and when children are aged 1 or 2, and £34 between birth and a child's first birthday.
- Scottish child payments, a new benefit introduced in February 2021 which provides families on means-tested benefits such as universal credit and its predecessors with an additional £10 a week per child aged 5 or under. The Scottish Fiscal Commission forecasts that the payment will initially be made in respect of about 150,000 children – assuming a take-up rate of around 80% – at a cost of £80 million per year.³⁴ The Scottish Government plans to increase the upper age limit to 15 by the end of 2022. Assuming a take-up rate of just under 70% for those newly eligible, this would benefit a further 215,000 children at

³⁴ Source: <https://www.fiscalcommission.scot/forecast/supplementary-costing-scottish-child-payment>.

an additional cost of £115 million a year.³⁵ In all, the policy is expected to take around 20,000–30,000 children out of relative income poverty, reducing the child poverty rate by 2–3 percentage points.³⁶ More recently, the SNP has pledged to double the payment to £20 per week by 2026, costing approximately £180 million on top of existing plans if introduced in 2024–25, for example, potentially lifting a further 20,000 children out of relative income poverty.³⁷ However, research by the Joseph Rowntree Foundation suggests the payment would have to be increased to £40 per week to meet the target of reducing the child poverty rate to 18% by 2024, unless there are increases in parental employment or wages.³⁸

- A number of smaller changes, including extending £200 winter fuel payments to families with a severely disabled child and introducing one-off job-start payments of £250 (or £400 if they have dependent children) for 16- to 24-year-olds moving from out-of-work benefits into employment.

Figure 7.1 shows the distributional effects of the main permanent changes implemented to date: the introduction of Scottish child payments, Best Start grants and carer's allowance supplement and the elimination of the under-occupation penalty (or 'bedroom tax'). On average, these benefit increases are worth about £80 per household per year across Scotland as a whole. But as one would expect, the gains are strongly skewed towards low-income households, peaking in cash terms at £240 a year (1.4% of income) for the second decile group.³⁹

As with income tax, the natural drawback of making the system more progressive is that it weakens work incentives. With more generous means-tested benefits, there is more to lose by coming off them.

³⁵ Ibid.

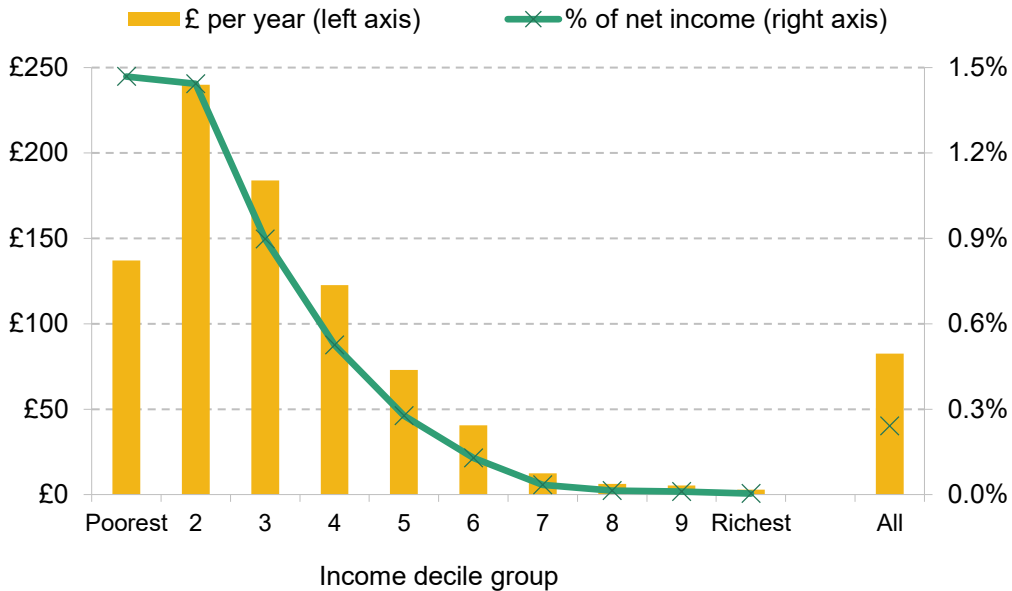
³⁶ Birt and Milne, 2021.

³⁷ Announcement in Nicola Sturgeon's campaign speech of 29 March 2021 (<https://www.snp.org/scotlands-recovery-will-be-in-scotlands-hands-nicola-sturgeon-addresses-snp-campaign-conference/>). Cost estimated by the authors based on Scottish Fiscal Commission estimates for current policy given above. Poverty projections reported in End Child Poverty coalition (2021).

³⁸ Birt and Milne, 2021.

³⁹ As discussed above in the context of council tax, the lowest income decile contains many households with significant financial assets who are therefore ineligible for many benefits.

Figure 7.1. Gains from applying Scottish rather than rUK benefit rates, ignoring temporary COVID-related measures



Note: Incorporates Scottish child payments, Best Start grants, carer's allowance supplement and the elimination of the under-occupation penalty. Households in Scotland are divided into 10 equal-sized groups based on their net income adjusted for household size using the Modified OECD equivalence scale.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on updated data from the 2018–19 Family Resources Survey.

A particular feature of the way almost all the new benefits and top-ups are means-tested – the exception being the end of the under-occupation penalty – is that entitlement is all-or-nothing, based on whether people are getting existing UK benefits. This was already a common feature of many benefit add-ons, such as free school meals and free prescriptions. Compared with introducing a separate means test, it makes them simpler for claimants to understand and claim, and simpler for the Scottish Government to administer. It might well be the right thing to do. But a consequence is that they are not withdrawn gradually as income rises, like standard means-tested benefits, but withdrawn suddenly – a ‘cliff edge’ – at the income level at which entitlement to UK benefits runs out (which varies according to family circumstances). There is thus a particular incentive to avoid crossing that threshold: someone earning an extra £1 can see their net income fall as a result.

This is not a major concern if the sums involved are modest. But it becomes a bigger problem, the more the benefits are increased. For example, with the Scottish

child payment at £10 a week, a parent on the verge of earning too much to qualify for universal credit (and therefore the Scottish child payment) would see no financial gain from increasing their (after-tax) earnings by £10 a week; if the Scottish child payment is increased to £20 a week, they would see no financial gain from increasing their (after-tax) earnings by £20 a week.

In addition to these permanent changes to benefits, the Scottish Government has made a number of temporary payments during the COVID-19 crisis:

- Scottish recipients of carer's allowance received double their usual six-monthly top-up payment (£460.20 as opposed to £230.10) in June 2020.
- In 2021–22, pandemic relief payments totalling £100 million will be paid to two (overlapping) groups of households.
 - A payment of £130 will be made in early summer to around 500,000 low-income families in receipt of means-tested discounts on their council tax bills via the CTRS. This might appear to be less generous than the additional £150 council tax discount being provided to CTRS recipients by most English councils, but in fact it is more generous. The payment in England merely reduces the council tax that most CTRS recipients still have to pay; if CTRS already reduces their bill below £150, the additional discount only covers their remaining bill (i.e. less than £150). In Scotland, CTRS already covers council tax bills in full for the poorest working-age families (unlike in most parts of England), and the £130 is a payment received on top of having their council tax covered. And it will be available to pensioner households, unlike in England (where, as in Scotland, the poorest pensioners receive 100% council tax discounts).
 - Two payments of £100 each (in September and December 2021) will be made to around 130,000 low-income families whose children are in receipt of free school meals.

8. Universal credit flexibilities and planned disability benefit changes welcome

As discussed at the start of this briefing note, powers to design and operate its own system of disability benefits have been devolved to Scotland, as have powers to vary how universal credit is administered and paid. The choices the Scottish Government is making are a clear attempt to address some of the criticisms levied at the UK government's approach to these issues.

On disability benefits, three new Scottish benefits are set to replace three UK benefits: child disability payment will replace disability living allowance for under-18s; adult disability payment will replace personal independence payments for working-age adults; and pension-age disability payment will replace attendance allowance. Child disability payments are being piloted from July this year in Dundee, Perth & Kinross and the Western Isles, with a full national roll-out planned for the autumn.⁴⁰ The roll-out of the adult payment is due to begin in Spring 2022; no date has been set for the roll-out of the pension-age payment.

The new disability benefits will not be radical departures from the existing ones, and rates of the new payments are planned to be the same as for existing UK benefits. But the Scottish Government promises a more 'person-centred approach', particularly for working-age adults. There will be fewer face-to-face assessments (which disability charities say can be stressful, especially for those with mental health problems),⁴¹ and any that do take place will be done by Social Security Scotland rather than private contractors. The time until a reassessment is needed will also be tailored more to individual circumstances: for example, those deemed to be unlikely to see significant changes in their condition will be reassessed no more than once every five years (with a maximum 10-year period between assessments). And awards for those with terminal illnesses will not be restricted to those with a life expectancy of less than 6 months.

⁴⁰ <https://www.gov.scot/news/child-disability-payment-pilot-date-announced/>.

⁴¹ See, for example, Mind (2017).

The intention seems admirable, and these changes have been welcomed by respondents to the Scottish Government's consultation on its proposals (Scottish Government, 2019). The question is how successful the changes will be in practice: whether the more individualised approach really does result in better-targeted assessments, whether the experience of claimants is improved, and whether face-to-face assessments can really be scaled back without reducing the accuracy of assessments. An obvious risk is that a lighter-touch approach to (re)assessments results in more people staying on benefits (at the taxpayer's expense) when their condition no longer merits it. But if the changes succeed, they can be a lesson for the rest of the UK.

For universal credit, Scottish claimants are given the option of receiving it in two monthly instalments rather than one, and to have the housing element paid directly to their landlord. The idea is that some claimants find it easier to budget this way.⁴² Such arrangements are possible in England and Wales under 'alternative payment arrangements', but only at the discretion of Department for Work and Pensions staff (rather than the claimant) if they judge that the claimant cannot otherwise manage their finances.

Providing this greater flexibility to claimants is a welcome improvement. The design of the universal credit payments system by the UK government, with monthly payments and claimants responsible for paying their own rent, was an attempt to encourage benefit recipients to manage their own budgets in the way they would if not on benefits (although in fact monthly salaries are much less the norm in the kinds of low-paid jobs that are most relevant for many recipients of universal credit, and couples who are both in paid work might not be paid on the same date in the month). But it is not clear that this experiment has been successful – claimants seem to struggle more with budgeting than the government envisaged, and the system has been widely criticised as a result – and there is no need to stick to the original design.

⁴² Note, however, that twice-monthly payments mean that universal credit is received even more in arrears than under standard payment arrangements: after a full first-month payment, recipients can opt into twice-monthly payments; if they do so, then a month after that initial payment they receive only half of the next month's payment, with the other half delayed just over 2 weeks (with this repeated each month thereafter).

As of August 2020, some 38% of new universal credit claimants in Scotland had taken up one or both of the flexibilities offered by the Scottish Government (down from 46% a year earlier, perhaps reflecting the different nature of claimants during the COVID-19 crisis), suggesting that people do find them useful – although around a quarter of those who opted for more frequent payments and a sixth of those who opted for direct payment to landlords subsequently reversed their decisions. The Scottish Government’s recent evaluation of how well the policy was working (Scottish Government, 2021c) found that claimants and private landlords reported a number of positive effects, although it also highlighted a number of problems, including a low level of awareness among claimants and several practical/technical difficulties (some of which are outside the control of the Scottish Government) which somewhat undermine the potential benefits of the policy.

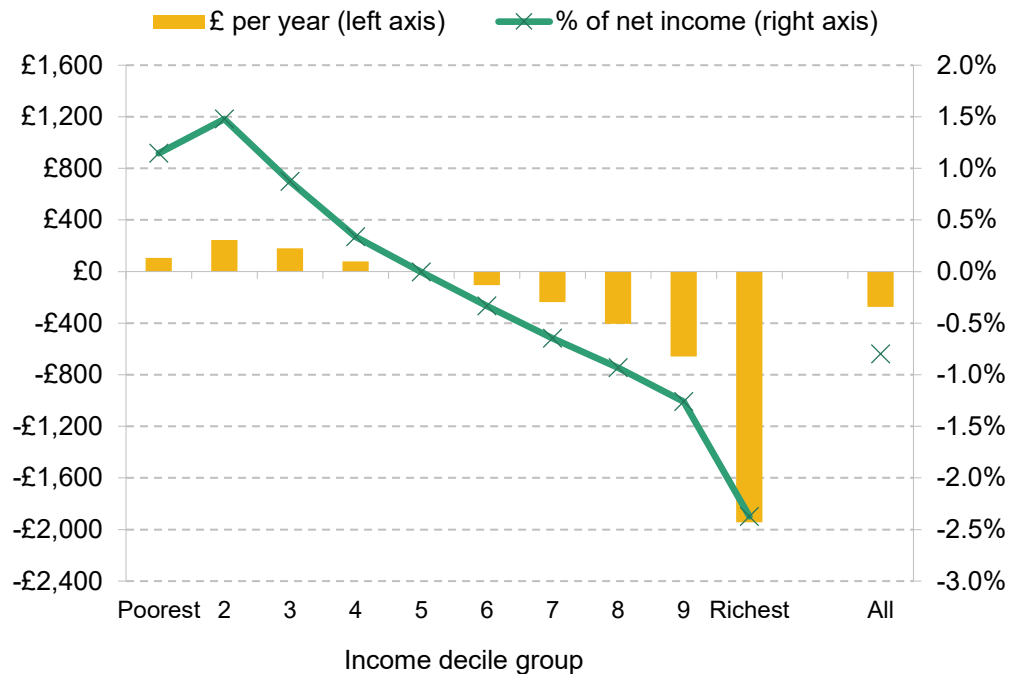
9. What is the overall distributional effect of Scottish tax and benefit policy?

Figure 9.1 shows the distributional effects of changes in devolved tax and benefit arrangements since 2016. To be more precise, it compares current policy in Scotland (excluding temporary COVID-related measures) with what policy would have been if there had been no further devolution since 2016 (so Scotland had rUK income tax and benefit rates) and no real-terms changes to taxes that were already devolved (council tax and CTRS).⁴³

In effect, it combines the three charts shown above for income tax, council tax and benefits, and it only includes those policies: most importantly, it does not incorporate business rates or LBTT, whose effects we cannot easily model.

⁴³ Scotland’s having rUK income tax and benefit rates can of course also be thought of as what would have happened if these policies were devolved but the Scottish Government made the same choices as the UK government.

Figure 9.1. Gains and losses from changes in devolved tax and benefit arrangements since 2016



Note: Includes the effects of adopting devolved rather than rUK policies on income tax, Scottish child payments, Best Start grants, carer's allowance supplement, the elimination of the under-occupation penalty and real-terms changes to council tax and CTRS since 2016. Households in Scotland are divided into 10 equal-sized groups based on their net income adjusted for household size using the Modified OECD equivalence scale.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on updated data from the 2018–19 Family Resources Survey.

This is only one possible way to analyse the effects of Scottish tax and benefit policy. Because our analysis shows the impact of real-terms changes to council tax since 2016, not differences in levels of council tax compared with England (which is difficult to do properly given the different council tax band thresholds in Scotland), it does not compare overall levels of tax and benefits in Scotland with England. Nor does it show the effect of all real-terms changes to taxes and benefits facing Scottish households since 2016: that would include the UK government's changes to the income tax personal allowance, benefit cuts, etc. which are outside the Scottish Government's control. But we think the question we are addressing is an interesting one.

On average, the policies amount to a net takeaway of about £270 per household per year across Scotland, or 0.8% of average income. But the distributional effects are highly progressive. The income tax and council tax rises are strongly concentrated at the top of the income distribution, costing the highest-income tenth of households 2.4% of their income (or £1,940 a year, on average); while the increases in benefits (and tiny reduction in income tax) mean that lower-income households gain on average. The biggest gains are in the second-lowest income decile group, who gain almost £250 a year on average, 1.5% of their income.

10. Conclusion

COVID-19 has dominated the past year. Most of the tax and benefit policy response to it has been done at a UK level. But there have been some Scotland-specific policies in devolved areas. The Scottish Government has made some temporary cuts to devolved taxes – along broadly similar lines to the rest of the UK, with business rates reliefs and cuts to LBTT on housing, but with more generous support for businesses and less of a stimulus to the housing market. It has also introduced temporary benefit top-ups for some groups (carers in 2020; low-income families with children and those receiving means-tested council tax reductions in 2021); these are more different from what was done in rUK, partly reflecting what was easiest for the Scottish Government to implement given the current state of devolved powers.

Once temporary COVID-related measures expire, what kind of tax and benefit system will Scotland be left with?

The permanent tax and benefit policies of the Scottish Government follow a strikingly consistent pattern: both over time and relative to rUK, they involve giveaways at the bottom of the distribution and tax rises at the top. Changes to income tax, council tax, business rates, LBTT and social security benefits have all contributed to that pattern.

The tax changes – particularly changes to income tax and business rates – have tended to complicate the system. In contrast, the changes to the way benefits are paid – the universal credit flexibility and the planned new disability benefits – should make life easier for claimants.

But the changes introduced by the Scottish Government largely represent tweaks to, rather than radical departures from, policy elsewhere in the UK. For example, the highest-profile differences from rUK are in income tax. Yet no income tax rates have changed by more than 1 percentage point, and the biggest difference from the UK – the higher-rate threshold – was essentially created by a UK change that the Scottish Government chose not to do. More new Scottish taxes and benefits are due to replace the UK versions. But of the new taxes due to come in, the Scottish Government has rowed back on its main proposed change, a large reduction in the tax on flying. And while the planned new disability benefits somewhat change the assessment process, which could have important benefits, they do not make major changes to underlying entitlement rules.

That is not necessarily a bad thing: the Scottish Government should not make big changes just for the sake of being different. But the area where the Scottish Government has most power to deliver radical reform is also arguably the worst-designed part of the current tax system: property taxation. The Scottish Government has control over all the main property taxes: council tax, business rates and LBTT. All three need radical reform. Yet while in all three cases it has reduced them at the bottom and/or increased them at the top, the Scottish Government – like the UK government – has ducked the need for fundamental reform. Council tax continues, ridiculously, to be based on 1991 property valuations. Business rates continue to discourage the development and use of business property. And LBTT, the most economically damaging of all, continues to lead to inefficient use of property. Ideally, as recommended by the Mirrlees Review, LBTT should be scrapped altogether and the revenue made up through an updated and reformed council tax and a reformed business rate that is (subject to confirming practical feasibility) based on land value rather than property value. Yet despite widespread acknowledgement of the failings of the existing taxes and despite two fundamental policy reviews, the Scottish Government has shown no sign of being willing to take radical steps in this or any other direction.

It remains to be seen whether more tax powers will be devolved to Scotland. But – just as important – it also remains to be seen whether the next Scottish Government will do more with its existing powers.

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