Scotland’s 53% marginal tax rate for middle earners illustrates yet another flaw with the Fiscal Settlement.

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It is an insufficiently appreciated fact that, following last November’s Scottish Budget, the marginal rate of income tax in Scotland, (or, to be precise, income tax plus national insurance), for employees earning between £43,430 and £50,000 will be 53%: this is more than 20 percentage points higher than the corresponding marginal rate for employees elsewhere in the UK. How this anomalous position has arisen illustrates yet another deeply unsatisfactory aspect of the fiscal settlement foisted upon Scotland following the 2014 independence referendum.

To understand what is going on, it is necessary to look in more detail at how the income tax and national insurance systems work, and how they interact. As regards income tax, the major fiscal reform brought in after the referendum was that the Scottish Government would have control of the taxation of non-savings, non-dividend income in Scotland. The Scottish Government does not have total control – setting the personal allowance, below which no tax is paid, is a power reserved to Westminster. But, apart from that, Scotland can set tax rates and band thresholds as it sees fit. The Scottish Government has exercised this power in successive budgets: and has set a lower rate of tax for the lowest earners than applies in the rest of the UK, and a higher rate of tax for higher earners. The Scottish Government has also increased taxes by not uprating the threshold above which the higher rate of income tax is paid. So in Scotland, in 2019/20, taxpayers will pay 41% income tax on earnings between £43,430 and £150,000. The position in the rest of the UK is that taxpayers will pay 20% on earnings between £12,500 and £50,000, and 40% on earnings between £50,000 and £150,000.

Now let’s look at national insurance, as it applies to employees. National insurance is an entirely reserved function – it is decided by Westminster, and applies uniformly across the whole of the UK. Employed individuals pay a national insurance contribution of 12% on those earnings falling between a lower threshold, (which will be £8,632 in 2019/20), and an upper threshold: on earnings above the upper threshold, a national insurance contribution of 2% is paid. The important point for present purposes is the upper threshold. This is set by the Westminster government to align with the higher rate threshold for UK income tax: so for 2019/20 it will be £50,000.

So for an unfortunate Scottish employee earning between £43,430 and £50,000, they will be paying a marginal rate of Scottish income tax of 41%, and a marginal rate of national insurance, set by Westminster, of 12%: giving an overall marginal rate of 53% for income tax plus national insurance. By comparison, an employee in the rest of the UK, with earnings falling in the same band, will pay a marginal rate of income tax of 20%, and national insurance of 12%, giving an overall marginal rate of 32%.

This matters. It matters for the individual, who is unlikely to have appreciated that what appear at first sight to be fairly modest proposals by the Scottish Government to exercise their control over income tax were going to interact with Westminster’s reserved powers on national insurance, to end up with such draconian consequences. But it also matters in a broader sense as well, because of the potential wider implications for the Scottish economy.

This is because of another aspect of the fiscal settlement, an aspect which has long been recognised as having potentially very problematic effects – namely, the Block Grant Adjustment, (BGA). Under the old, pre-referendum, funding system, most of the Scottish Government’s funding came via a block grant from Westminster: and the size of this block grant was determined by the Barnett Formula. But since the Scottish Government now receives directly the revenues raised from income tax in Scotland, a corresponding reduction was made to the block grant; (and similar reductions are made for other devolved taxes.) The initial size of the adjustment was designed to be neutral. But thereafter, the size of the BGA increases each year in line with the growth in per capita income tax receipts in the rest of the UK: (formally, the BGA relating to income tax increases in line with the growth rate in the Scottish population, multiplied by the growth rate of rest of UK per capita income tax receipts.) This system has, however, the inevitable consequence that it pitches Scotland into an economic race with the rest of the UK. If we grow our per capita income tax receipts faster than the rest of the UK – well and good. But if we grow more slowly, the BGA penalises Scotland, and public expenditure in Scotland is squeezed.

The danger with the BGA based approach is that the resulting system is potentially unstable, with the risk of Scotland getting trapped in a self-reinforcing cycle of relative economic decline. Under the worst possible scenario, a Scottish Government attempting to protect public services by raising tax rates would have the effect of damaging Scotland’s economic performance relative to the rest of the UK: which would incur a BGA penalty, which would erode the size of the Scottish budget: which could trigger further increases in tax rates: and so on.

Of course, this potential risk, under the BGA system, does not mean that a Scottish Government should not raise tax rates relative to the rest of the UK. But it does mean that any such increase would have to be carefully fine-tuned in the light of the strength of the Scottish economy: and finely adjusted to avoid building any undue disincentives into the system. What is quite clear, however, is that such fine tuning is impossible when, due to the design flaws in the system, a relatively modest tax change by the Scottish Government suddenly results in a 53% marginal tax rate at a key point in the earnings scale: and a greater than 20% differential in marginal tax rates relative to the rest of the UK.

All of the above adverse consequences arise because the fiscal settlement is a botched job: an ill thought through mash-up of devolved and reserved powers. Which leaves the very good question of – how did we get into this situation. The important thing to remember is that, from the point of view of the right wingers on the unionist side of the fiscal settlement negotiations, the design of the fiscal settlement has much to commend it. This was brought home to me very forcibly when, at a seminar before the fiscal settlement was concluded, I challenged a very senior Treasury official that Scotland would not have enough powers to make what was proposed actually workable. Not so, was the confident reply: Scotland does have the required powers: what it will need to do is to lower taxes relative to the rest of the UK, making itself a haven for high earners. According to this, mistaken, view, the economy, and Scotland’s tax revenues, would ultimately soar ahead in line with the standard neo-liberal orthodoxy.

In fact, a cynic might also say that the fiscal settlement design has another advantage from the Westminster viewpoint, because it opens up an opportunity for Westminster to game the system. If Westminster decides to increase the higher rate income tax threshold for the rest of the UK at a higher rate than inflation, then the resulting decrease in income tax revenues will be partially offset by the extension of the band over which 12% national insurance contributions are paid. But since this increase in national insurance contributions also applies to Scotland, and since these revenues go to Westminster, what Westmister has actually been able to do is to pre-empt part of Scotland’s taxable base: in other words Westminster has benefitted at the expense of potential revenues for the Scottish Government. Of course, surely such considerations would have played no part in Westminster’s decision in its 2018 Budget to increase the rest of UK higher rate threshold from £46,350 to £50,000, well above what would have been required for an increase in line with inflation.

So, as far as a certain type of neo-liberal unionist goes, what’s not to like about the fiscal settlement. If the Scottish Government wants to succeed in the inevitable economic race with the rest of the UK – then it should embrace neo-liberal, low tax policies. The fact that the resulting small-state, cut-throat society is quite contrary to the preferences of the majority of Scots is not merely an irrelevance – it is a positive advantage from the unionist viewpoint. And if the Scots don’t take their neo-liberal medicine, and if they eventually slip into a cycle of relative economic decline vis-a-vis the rest of the UK – then this just shows that they were not capable of exercising the powers that they were supposedly given.

The surprise about the fiscal settlement is not that the unionist side proposed such a toxic design: from their point of view, the logic is perfect. The surprise, and the tragedy, is that the Scots agreed to it. At the time, I described this decision as Scotland’s Fiscal Flodden: and nothing has happened subsequently to change that view.

Having found ourselves in this trap, it’s easier to say what we shouldn’t do, rather than what we should do. What we certainly shouldn’t do is to regard the present fiscal settlement as the norm, or acceptable, or a fair platform upon which the competence of the Scottish Government should be judged. In this respect, the SNP have compounded their original sin, of agreeing to the settlement, by implying that they are ready to be judged by their success in making it work. In doing so, they are underplaying the likelihood of failure, and the risks inherent in their current policies: and if, or when, things go wrong, they are then setting themselves up to take the responsibility for this. Instead of the fiscal settlement being blamed, what will be criticised is the Scottish Government’s competence in managing the economy; and this will be used as an argument against future independence. Under the present constitutional arrangements, the SNP will find it very difficult to wriggle out of this position. Which is yet another argument for an early independence referendum, in order to break directly out of the fiscal settlement trap.

Note

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