OFFICIAL REPORT
AITHISG OIFIGEIL

Finance and Constitution Committee

Wednesday 19 April 2017

Session 5

The Scottish Parliament
Pàrlamaid na h-Alba

Wednesday 19 April 2017

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FINANCE AND CONSTITUTION COMMITTEE
12th Meeting 2017, Session 5

CONVENER

*Bruce Crawford (Stirling) (SNP)

DEPUTY CONVENER

*Adam Tomkins (Glasgow) (Con)

COMMITTEE MEMBERS

Neil Bibby (West Scotland) (Lab)
*Willie Coffey (Kilmarnock and Irvine Valley) (SNP)
*Ash Denham (Edinburgh Eastern) (SNP)
*Murdo Fraser (Mid Scotland and Fife) (Con)
*Patrick Harvie (Glasgow) (Green)
*James Kelly (Glasgow) (Lab)
*Liam Kerr (North East Scotland) (Con)
*Ivan McKee (Glasgow Provan) (SNP)
*Maree Todd (Highlands and Islands) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Charlotte Barbour (Institute of Chartered Accountants of Scotland)
Alex Cobham (Tax Justice Network)
John Cullinane (Chartered Institute of Taxation)
Professor Richard Murphy (City University of London)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance and Constitution Committee

Wednesday 19 April 2017

[The Convener opened the meeting at 10:00]

Scottish Approach to Taxation Inquiry

The Convener (Bruce Crawford): Good morning and welcome to the 12th meeting in 2017 of the Finance and Constitution Committee. Neil Bibby has sent his apologies. I ask members to switch off their mobile phones, or at least to put them into a mode that will not interfere with our proceedings.

The only item on our agenda today is evidence on the Scottish approach to taxation, with a particular focus on incorporations, and we are joined for that purpose by Charlotte Barbour, who is director of taxation at the Institution of Chartered Accountants of Scotland; Alex Cobham, who is chief executive of the Tax Justice Network; John Cullinane, who is tax policy director at the Chartered Institute of Taxation; and Richard Murphy, who is director of Tax Research UK. I welcome all the witnesses who are here to help us with our proceedings this morning. Maree Todd will kick off with the first question.

Maree Todd (Highlands and Islands) (SNP): There has obviously been a change in the level of incorporation in the United Kingdom as a whole over the past few years, some of it because of tax planning and some of it probably precipitated by the financial crash in 2008, when many people lost their employment and became self-employed. Do the witnesses have any evidence on whether that change is levelling off or whether it is likely to continue and grow? I know that changes have recently been made by the UK Government to dividends, so is that likely to impact on the level of incorporation in future?

John Cullinane (Chartered Institute of Taxation): I am not sure that I have that evidence to hand, but the Office for Budget Responsibility at UK level projected that the trend was likely to continue. The change that the Chancellor of the Exchequer made to dividend tax in the previous UK budget was clearly intended to reduce that, but if you look at the effective marginal rates of tax on incorporated versus unincorporated businesses, even after that change, you will see that it has not levelled things up. It depends on income level and all sorts of other things, but the change has probably moved about a quarter in the direction of levelling things up, so it is unlikely that it will, of itself, stem that flow.

Charlotte Barbour (Institute of Chartered Accountants of Scotland): As long as Scottish rates are different, there could be an impact. I like the way in which the Institute for Fiscal Studies paper discusses the problem; it contains some interesting statistics. As the IFS rightly says, you are at the confluence of income tax, corporation tax and national insurance. My reading of the situation in broader terms is that, because the majority of people want to minimise tax costs, as long as there are differentials, incorporations will continue to apply, because it is cheaper to operate that way.

Professor Richard Murphy (City University of London): I have studied the data and written a couple of papers on it. The change in the incorporation pattern in the UK happened when Gordon Brown introduced a 0 per cent effective start rate for corporation tax in, from memory, 2000 or 2001. At that point we had 1.5 million companies in the UK, and now we have about 3.8 million. That does not mean that they are all the same. The turnover is quite phenomenal. A very large number of companies in the UK last for four or fewer years, and quite a significant number last for less than two years—which may well indicate a pattern of tax evasion, by the way. I think that they are extensively used for tax evasion, which is a much bigger issue than the differential on the rates.

The pattern of using companies for tax planning started in about 1986-87, when national insurance first encouraged incorporation and the payment of dividends. That was the case from then on. It was a well-known pattern throughout that period, and it simply became more attractive—under various rule changes—until the dividend tax came in. The dividend tax will not change that, as John Cullinane and Charlotte Barbour correctly say. A differential remains, and it is still cheaper to incorporate and pay yourself in dividends than to trade as a sole trader, as a partnership or as a limited liability partnership, so incorporation remains attractive for tax purposes.

However, I do not think that that is the only reason. There are now artificial, disguised employments being run through companies, and there is enormous pressure from many companies to have their disguised employees incorporate. That creates an incentive for incorporation as well. Those are not genuinely trades; they are simply people who are being exploited by the employer as much as they are exploiting the tax system. We are seeing significant patterns of tax abuse through companies as well.

Alex Cobham (Tax Justice Network): I will add something about the difference that we have seen. If we talk to people in the financial services sector, for example, we see a switch from people setting up companies to take their income because their mates are doing it and they are seeing it in the sector to a refusal to employ people other than through a company structure. We have kind of locked it in, and it has become a systemic behaviour. That is much harder to unravel than changing the incentives of individuals, if it is the employers themselves who are demanding it, as they often are in financial services in Edinburgh, for example. How we unravel that is a different kind of problem from how we change the decisions that individuals might make about how aggressive to be on their own avoidance, which clearly comes back to policy makers.

Charlotte Barbour: To take things back one step, I think that we are discussing two slightly different things. On Alex Cobham's point, there is the situation in which people have been employees or are employees, and the elephant in the room is probably national insurance, because employers find that expensive. If we amalgamate that with employment rights and other things like that, the question arises as to whether those employees—if that is the word—could cost less, so they are then taken off payroll. That is disguised remuneration, or that kind of situation. Those kinds of people are at the bottom end and the top end of the pay scale.

That is one sector of people that we might want to consider, but there is a completely different sector of people who are running a genuine business—an accountancy practice, making widgets or doing whatever they do. Someone starts up, working on their own and getting on with it, and then they reach a stage where they think, "Is this the way to go about things?" They might stay on as a sole trader or a partnership, which is in income tax. As things get bigger, people tend to be encouraged to head towards corporation tax and incorporating. A company is a part of that package and of the overall decision. Those situations are slightly distinct, and you are looking at slightly different sectors of people.

The other rider that we should put in here is that this is a UK problem. Anything that we do here in Scotland is an element that interacts with that. It is not a Scottish problem as such.

Maree Todd: On that note, I want to ask you all another fairly general question on the particular challenges for the Scottish Parliament. Clearly, income tax was not fully devolved to Scotland. There are limits. I would be interested to hear your thoughts on the limits and on which aspects of income tax were devolved.

Charlotte Barbour mentioned the confluence between the other forms of taxation that people might face—corporation tax, dividend tax and national insurance. What limits are placed on the Scottish Government when it comes to altering income tax by the fact that it does not have control over all those other forms?

John Cullinane: There is a specific problem for Scotland with its devolved regime in that regard. You have control over the main income tax rate, which is the main tax that someone will pay if they are a self-employed sole trader, whereas corporation tax has not been devolved, and neither has the dividend tax rate. In Scotland, one side of those two choices—incorporated or unincorporated—will be heavily influenced by what the Scottish Parliament does whereas, under current rules, the other side will not be influenced at all. Therefore, it is difficult for you to balance that up in the Scottish context without a change in the rules or some idea of what the UK will do.

Charlotte Barbour: The Scottish Parliament probably has as much flexibility with income tax as the UK Parliament does. The extent to which it is possible to raise rates or lower them versus spending is politically driven. The devolution of income tax rates and bands does not give the Parliament huge scope. You can have a radical approach to Scottish taxation but, in practical political terms, there is not as much flexibility on income tax as initially appears in relation to the amount of money that comes in.

Professor Murphy: I agree to some degree with John Cullinane and Charlotte Barbour on the current practical constraints, but let us consider what those mean and what that implies.

First of all, let us go back to incorporation, on which Scotland has a dire record. According to the records of Companies House—which, admittedly, is in Wales—there have been no prosecutions in Scotland under Scots law for breaches of the Companies Acts since 2008. In those terms, Scotland is not the wild west but the wild north. It appears that there is no enforcement of company law in Scotland. Why that is the case is a good question and one that the committee might want to follow up. It may be that there are prosecutions under other law, but perhaps they are just not taking place at all. The number of prosecutions is tiny anyway.

Let us put this in the context that Scotland does not appear to be enforcing the existing law with regard to the submission of company accounts. My research shows that companies that do not submit company accounts also do not submit company tax returns. At least 1 million of the companies that exist in the UK each year do not submit corporation tax returns. Of those, 600,000 are with the consent of Her Majesty's Revenue and Customs because, when a company is incorporated, it is sent a form that asks whether the company trades and, if somebody ticks the box that says no, they get a letter back from HMRC saying, “Thank you very much. We will contact you in five years.” Most people take that as an invitation to make no declaration.

A procedural change could be made straight away in Scotland if you wish to discuss with Revenue Scotland changing that approach and demanding a corporation tax return from every company that has a registered office in Scotland, for example. That would be one way of tackling the issue and trying to collect the tax that is not paid. A second way would be to demand that the Scottish register of companies—of course, there is a Scottish register—insists that the accounts that are due be filed, because that does not appear to be the case at present.

A lot can be done at the basic level of incorporation in Scotland because there is Scottish law on the issue that needs to be examined and administrative practices need to be reformed. We are then into the problem that tax systems do not work in the way in which taxation affairs have been devolved. I am still a practising chartered accountant as well as an academic. In the real world of accountancy, we think about tax systems as a whole. Some very small parts of a total tax system have been devolved to you and you can do very little with them, to be blunt. What you can do will often make it end up looking as though you have made things worse, because that is the way the system was designed to be, I suspect.

You cannot play with the interaction between income tax and national insurance, although it is key with regard to incorporation, because you do not have power over national insurance, which makes little sense because it is the easiest tax to devolve because it is easier to identify where employees are than just about anything else. You cannot play with the difference between income tax on earnings and income tax on non-earned sources. However, in the current situation of incorporation, somebody can clearly opt in or out of Scottish taxation by choice. If they decide to pay themselves a salary from the company, they are within the scope of Scottish income tax and, if they decide to pay a dividend, they are not. We could not have come up with a more absurd tax system for Scotland than that.

To be frank, my suggestion is that you need to go back to the negotiating table as soon as possible after 8 June and ask for a better settlement. Whatever the future is and whatever the party is, you have been left with a very poor foundation.

The Convener: I guess that that will spark off a few supplementary questions. [*Laughter*.]

Adam Tomkins (Glasgow) (Con): I want to take you back to the point about enforcement to ensure that I have understood it correctly. Are you claiming that there have been no prosecutions against companies incorporated in Scotland under UK company law since 2008 or that there have been no prosecutions specifically in the Scots courts, notwithstanding the fact that company law is a reserved area of the law?

10:15

Professor Murphy: I am working on the basis of the information supplied by Companies House, which has consistently said, since 2008, that there is no data on any prosecutions in Scotland under company law. It may be wrong, but that is what Companies House keeps on telling me. I keep on asking and I do not get any other information.

Adam Tomkins: Do you ask the follow-up question as to whether there are prosecutions brought against companies located in Scotland in the courts in London, which is where I would expect those prosecutions to be brought?

Professor Murphy: I have not asked that question.

Adam Tomkins: Right.

Professor Murphy: I do not understand why that would be the case, given that they tend to try to bring prosecutions in the area where the registered office is.

Adam Tomkins: It may be for reasons of legal expertise in the relevant courts.

Professor Murphy: It may be, but in that case it would still be surprising that Scotland has no legal expertise. I would still raise that question.

The Convener: Are there any other supplementary questions on that subject before I move to some of the more behavioural issues that underlie such questions?

Murdo Fraser (Mid Scotland and Fife) (Con): I have a follow-on point to Maree Todd’s question about behavioural change. I will start with you, John Cullinane, because you mention behavioural change in your submission. The Scottish Government decided to go down a different path on income tax for higher earners, which has had an immediate impact in the current financial year and, if we continue on the current trajectory, will have a more significant impact as we get towards 2020 and 2021. To what extent do you think that the differential in income tax rates between Scotland and the rest of the UK is likely to drive behaviour change in taxpayers, leading to more higher earners in Scotland going down the incorporation route?

John Cullinane: Any time anyone wants to put up a tax or lower a threshold, the obvious response is that people will vote with their feet in various ways, but it is quite important to get as much evidence as possible about the extent to which that is the case. It is all about how much. It is very difficult to say. Even if you look at the UK level, when the rate went up from 45 per cent to 50 per cent, it was there for about two years and a lot of the evidence about any behavioural adjustment was really around temporary adjustments whereby people accelerated dividends at one end and postponed them at the other. There is a difference between temporary effects around a change and the on-going effects.

You hear a lot of people saying that they could go and work in England, particularly if they live close to the border. However, when the UK rate went up to 50 per cent, I am not sure whether there were as many of the permanent, on-going reactions as was trailed, but then again it was in for such a short time.

Of all the different reactions that you can think of, if the differential between Scotland and the rest of the UK is there for a long time and is expected to continue or widen, you might expect some investment decisions at the margins to be affected and you might find people looking out more. However, of all the various ways and means that people might go about trying to get out of a higher tax burden, I would have thought that incorporation would be the most likely route to be taken. As Charlotte Barbour was saying, if you are a growing business, it is an issue that comes up anyway and for reasons of legal protection and many other reasons besides tax. It is on the agenda anyway for a certain type of taxpayer.

There is evidence over a long period elsewhere—as Richard Murphy was saying, it goes back to the beginning of the century at the UK level—of people reacting to a tax burden by taking the route of incorporation. Of all the various behavioural responses that might come about, incorporation is one of the easiest to see happening. However, that is just a hunch and is based loosely on historical evidence at the UK level. One of the problems is getting the direct evidence—by the time you have collected that evidence and assessed it, you are five years down the track with the issue. It is quite a difficult problem.

Alex Cobham: It is worth thinking about the underlying dynamic, which is that it is always politically appealing to talk of competition, and that talk goes well beyond any evidence that is in favour of it. The ideological lure of thinking that a place is competing on tax by cutting the rate is not borne out by the evidence, but the risk is that people can go a long way down the road, as John Cullinane said, and give up a lot before they find that out.

In its extremely ill-advised moves on corporation tax—in cutting the statutory rate—the UK Government has continued year on year with a policy that its own analysis, never mind that of the Office for Budget Responsibility, predicts will have zero effect on increasing investment or increasing the tax base. The UK Government is making cut upon cut when its own analysis shows that that is a pure giveaway with no expected economic benefit, and yet the justification that is given is the need to have the most competitive tax rate. That sounds appealing but, without the evidence behind it, it is an extreme position to take.

As Richard Murphy said, the risk in having fragmented tax powers that form only a part of the overall picture is that, although the demand may be relatively appealing politically, the prospect of falling into a race to the bottom—evidence aside—is probably greater than the prospect of, with such narrow powers, being able to take on the introduction of the more progressive taxation that there is a clear public demand for here and in the rest of the UK.

You face an unfortunate choice between pursuing something that is more progressive and which reflects public demands here but which it is difficult—perhaps impossible—to deliver within the limits of the powers that you have and not risking an increased likelihood of falling into a race to the bottom. In the European Union, things such as the state aid rules were put in place very early to limit competition between jurisdictions. For that reason, all things being equal, a further splintering of tax powers would probably not be wanted, even though the political context might demand it because the divergence between public views here and the political positioning at Westminster might create an irresistible case for further devolution of tax powers.

Professor Murphy: A couple of evidential sources suggest that incorporation is easy in the context of an existing source of income. We know that. I do not think that changes in Scottish tax rates will really increase the attractiveness of incorporation at the moment—the trend is already there and there is little evidence that such changes will alter the situation much.

There is evidence that people do not fundamentally change their lives for tax reasons. Incorporation is easy, but few people move home for tax purposes. In 2010, it was widely discussed that a lot of people would leave London and go to Switzerland because of the onset of the 50 per cent tax rate, and it was thought that one easy measure of that would be the demand for places in English-language schools in places such as Geneva. However, that demand actually went down rather than up, which was quite interesting. There was no surge in people leaving London for that reason.

The number of tax exiles is tiny. Quite a lot of research on the subject has been done in the USA—it has lots of tax borders, which makes such research a lot easier, and there is no disincentive from cultural and other differences to moving across a state border. That research has found that people will not move 20 miles to reduce their tax rate. Income tax in some states is up to 8 per cent whereas, in neighbouring states, there is no income tax at all—there might be a sales tax, but people can overcome that by going back to the state that they just came from. There are massive opportunities for arbitrage.

People will not move, lift their children out of their schools, leave the golf club or whatever it might be to save tax; those things are much more important than tax. Much as I think that tax is important, and—this is a shameless plug—I wrote a book called "The Joy of Tax", it is not that important to people after all.

Charlotte Barbour: We need to be careful not to overemphasise the point on incorporation, because about 85 per cent of people who pay income tax are employees. In Scotland, all our figures for self-employment are slightly lower than those for the rest of the UK, and people cannot automatically flip out of employment into a company. The process is not as simple as that, and there are plenty of barriers to it for a host of reasons, which include psychological, behavioural and employment reasons. We need to be careful not to get too caught up in that; it is a factor that we need to be aware of, but it is not the be-all and end-all.

I draw attention to the fact that, while I accept that income tax is only part of the toolkit of powers that Scotland has—we do not have national insurance or corporation tax—that does not mean that the glass has to be seen as half empty. For instance, we control the amount of income tax that comes in, and we have discussed quite a bit at work recently the fact that we might start to see a pulling apart of income tax and national insurance. For decades we have all argued that they are six of one and half a dozen of the other—they are both just a tax on income—but, if one is a devolved matter and one is a reserved matter, they might start to pull apart more.

Murdo Fraser: This is an interesting discussion. It sounds as though you are all saying that the behavioural drive towards greater incorporation is likely to have only a marginal impact that will be no greater in Scotland than in any other part of the UK. Is that a reasonable summary of your position?

Professor Murphy: Yes.

Charlotte Barbour: Yes.

Murdo Fraser: If you agree with that, can I ask a slightly different question?

John Cullinane: I am not sure that I totally agree. I agree with all the comments from my colleagues about not thinking that tax drives everything, but for someone who is self-employed and has a growing business, incorporation is not like moving the kids out of school—it is on the agenda anyway.

I agree with the comments that were made about large companies that are trying to force down employment costs and which think that it would be a nice idea to get people off the payroll. Once they have done that, they will not leave those people as self-employed contractors—they will ask them to set up a company. In that way, they can deal with other companies and therefore, it is believed, be safer against an audit by HMRC of people's employment status. The situation is not as simple as that, but the two phenomena are quite closely related.

The most recent UK budget contained the national insurance change that was withdrawn, which was all about the imbalance between tax on employment and tax on self-employment. The budget also contained the dividend tax change. Those were the two biggest measures, so the issues are clearly of concern to policy makers at UK level, even with all the concerns about Brexit and so on. They are probably two of the biggest issues for the UK tax system. The world will not fall apart if they are not fixed, but those threats to the UK tax base are likely to continue for some foreseeable time, because it is not obvious how the imbalances are to be resolved.

I agree that the extra Scottish dimension is probably not significant at the moment, but it is an unhelpful feature that Scotland has control over one side of the equation but not the other. There is a specific warning light for Scotland, even though it is not a Scottish problem.

The Convener: Before we move on, does Murdo Fraser have a question on a slightly different area?

Murdo Fraser: My question follows neatly on from what John Cullinane just said. I will ask about alignment between employment, self-employment and incorporation, which he just touched on. The chancellor tried to address that in the budget, but such was the reaction that he had to make a swift retreat. Given the political backdrop, how realistic is it for a Government to bring about that alignment?

10:30

John Cullinane: At one level, one could be even more pessimistic, because the change that the chancellor tried to bring about was tiny compared with the size of the imbalance. As my colleague Charlotte Barbour said, the elephant in the room is employers' national insurance. If we compare the situation of an employer, or an engager, to use a more neutral term, who employs somebody versus an employer who takes on a self-employed contractor—if they can lawfully and properly do that—the biggest element in the equation is employers' national insurance, which is more than 13 per cent of the payroll. That is a clear driver for employers to seek to minimise their employment costs.

The UK has a terrible tradition of budget surprises. A budget is almost disappointing unless the Government produces several rabbits from a hat. A self-employed person who was facing a couple of per cent extra in national insurance contributions over a couple of years would probably have heard about it first on the "News at Ten". There was no attempt at a big warm-up with a Government consultation that said, "It is nobody's fault but we have this huge imbalance in the tax system—what are the options for doing something about it?" The Government just sprang a surprise and then it was surprised when there was an adverse—and slightly ill-informed and hysterical—reaction.

The Chartered Institute of Taxation believes that, if there was a much more thoroughgoing consultative approach, we could engender a much better public debate. I do not know that anyone will ever view paying tax as a joyful experience, but people are realistic. For example, people have not rioted in the streets about the increase in the state retirement age over the past few years. People can accept unpopular or difficult things, but they need to understand the reasons. Time needs to be taken and there needs to be debate. The main lesson that comes out is that we need to move away from these terrible surprise budget measures.

Professor Murphy: Murdo Fraser hints at a key issue that has been suggested as a basis for Scottish taxation, which is the ability to pay. In this sense, alignment requires people who are on the same level of income to pay the same level of tax. That is one of the fundamental principles. Horizontal equity is necessary in the tax system if vertical equity is to be delivered, which is what proportionality requires—that goes right back to Adam Smith.

There are a large number of threats to such alignment in the UK tax system. One concerns incorporation versus employment versus self-employment. There are good reasons why the self-employed do not pay as much tax as the employed. I have been self-employed and employed. I am in the curious position of being employed after 35 years of self-employment, and the novelty of having somebody putting money into my bank account at the end of every month without having to send them an invoice that threatens them with legal action or anything else is amazing. I enjoy it enormously and the difference is staggering. I assure members that being self-employed is not the same as being employed, so I see some reason for non-alignment, because the risk profile is genuinely different.

However, we have many other areas of non-alignment. One of the important issues is tax evasion. The Organisation for Economic Co-operation and Development has issued a paper in the past two weeks that points out the massive imbalance in a society where the tax authority does not pursue tax evasion with the right amount of vigour. I do not believe that the UK does enough on that; I believe that HMRC massively understates the scale of tax evasion in the UK economy.

The fact that a million companies a year do not submit corporation tax returns suggests that there is negligence—and I use that word quite carefully. I suggest that there is negligence on the part of HMRC in the administration of corporation tax and that HMRC does not pursue the issue properly. When I checked how many penalties for non-submission of corporation tax returns were collected, I found that in one year—I think that it was 2011—99.9 per cent of the penalties were not collected, which shows that issuing them is a pretty meaningless exercise and that they are not doing their job.

The OECD has argued that tackling tax evasion could increase productivity by 1 per cent, as well as improving the tax yield. Productivity would increase because there would be a level playing field between the cheats and those who are honest, and that is a most critical alignment. If people believe that the private sector is a foundation of the economy, I suggest that treating it with respect by collecting tax from those who are cheating is a fundamental principle of taxation. That is another essential part of horizontal equity, but we do not have such horizontal equity. It could be created, but it cannot be created by the dividend tax, because that is on only one source of investment income and it is clearly targeted at dividends from incorporated entities.

I will put that in context and go back to the numbers that John Cullinane talked about with regard to such abuse. We may be talking about a loss to the UK tax system of £3 billion to £4 billion as a result of incorporation, which is half of 1 per cent of UK taxation. I am not saying that that is not an issue, but let us put it in context. There are more important issues on which we should be looking for alignment. Rental income, which people are now being encouraged to put into companies because of the changes in tax relief on borrowing, is another area where it may well be essential to create an alignment. Alignment between incorporation and self-employment is not the only issue to be looked at; there are many more to consider before a tax system can be created that accords with the principle of proportionality.

Ivan McKee (Glasgow Provan) (SNP): I thank the panel members for their comments so far. I will touch on a couple of areas, both of which have been mentioned. The first is the behavioural impact that the differential income tax bands in Scotland might have. I welcome your comments about the unimportance, to a large extent, of the small differentials in influencing behavioural change. The tax differential amounts to about £400 a year and affects 10 to 15 per cent of the taxpaying population.

It would be nice if we had evidence about another tax differential of about £400, which we have had in place in Scotland for a number of years and which affects a much larger number of people. Of course, I am talking about the council tax differential. Have you seen any evidence of people moving from England to Scotland to save £400 on their council tax?

Another thing could have an impact on businesses when they are deciding where to set up. I have on several occasions been in the position of spending other people's money and my own in deciding where to set up manufacturing businesses across Europe. In my experience, the differential in income tax is well down the list of factors that businesses consider. They look at logistics, the supply chain, whether they will be in the single market, the availability of skilled labour and where their suppliers are. I am interested in your comments on that before I move on to my next question, which is about incorporations.

Charlotte Barbour: I agree that we do not hear about a lot of people doing much because of a £400 difference in income tax. We all need something to grumble about, and that is one of those things. I have no statistical evidence on this, but what I do hear a lot more is general comments not about income tax but about council tax increases or land and buildings transaction tax being slightly higher. As I said, that is only anecdotal evidence, but it suggests that, rather than looking at taxes in isolation, people are looking at the overall package.

On your point about businesses, I agree that tax in isolation is not the ultimate driver of whether a business will invest, but in courses that are offered to people to invite them to consider where they might want to invest and what factors they might consider, tax is an element.

Alex Cobham: The international evidence is clearly in line with what Mr McKee said. Everyone from McKinsey & Company to the International Monetary Fund to the Tax Justice Network is in entire agreement that tax does not feature in the location decision. The decision is made and then the company may lobby for tax breaks, but it knows where it wants to be and its location decisions are based on the much more substantive elements. The risk of Brexit is that it will take us out of state aid regulation and open up the UK as a whole to lobbying by businesses for tax breaks, which would have been batted off before as illegal. That is one of many risks.

Professor Murphy: I will mention a comparison with the Irish situation because it is almost obligatory to do so when discussing corporation tax. I declare an interest in that I have an Irish passport—with my name, that is not surprising.

In Ireland, we see something that is quite different from what we have just discussed. Real businesses do not locate on the basis of tax. We will not find many substantial businesses in many of the world's most recognised tax havens. Pharmaceuticals are not developed in the Cayman Islands, Jersey, the Isle of Man or anywhere like that, although vast numbers of patents for those products are held in those places. There is a disconnect between the substance and the form in which a lot of the world is taxed. Corporation tax makes that possible because the legal form of the company lets the substance of the transaction be separated from the legal form in which it is taxed.

Some countries—Ireland is a perfect example—have encouraged the location of profits without necessarily attracting much substance in terms of people. I accept that some people go to Ireland, but there are not that many in relation to the profits that are apparently recorded there. That is why we ended up with what Paul Krugman called leprechaun economics in respect of Irish gross domestic product, which can be so massively restated depending on whether Apple decides to record its profits in or out of that country. That has nothing to do with the productivity of Ireland as a whole.

That means that we have to be very careful that we are looking at substance. If we are interested in having substantial and real economic activity, incorporation, taxation and other such things make little difference. Instead, we should look at infrastructure, people and the quality of the law and health services—so that people turn up in the morning fit for work—as the basis for locational decisions.

If people are looking to provide opportunities for tax abuse, they can by all means go into tax competition, but that is a very dangerous path—many of the world's tax havens are looking decidedly dodgy on their own finances.

Ivan McKee: Thank you. I want to follow up on some of the comments about incorporation, but perhaps take a step back. Clearly, incorporation is a good thing, because it signals innovation, entrepreneurship, people starting up businesses, wealth creation and the rest of it. Looking at whether we are creating enough start-up businesses and so on is one of the ways in which we check and measure the economy's health, but you have identified an area of overlap where people who should be employed are using incorporation as a means of avoiding tax.

I commend Richard Murphy's comments about the risk profile, because I have been in the same position. Having been on both sides of the fence—in other words, having been employed and self-employed—I think that the risk of not knowing whether you are going to get paid or whether you are ever going to get a holiday is worth quite a lot, and that needs to be recognised on the reward side, too.

I just want to probe the tightening of the rules around IR35 with regard to those on either side of the fence. Is the problem that the rules are just not strict enough in allowing people to move from one side to another? In my experience, they are fairly strict. For example, in order to be treated as a legitimate corporation, you need to demonstrate that you have several customers, provide your own equipment and so on. Are the rules not strict enough, or are they not being enforced properly? What is the issue here? Some of the examples that you have mentioned and which I have heard about clearly constitute employment and from my experience in business, I am very surprised that people are able to incorporate to do some of the things that they do.

John Cullinane: I do not entirely agree with the point about tax having no impact other than in extremely abusive cases. There are situations where lots of other factors come into play, but incorporation is a quantifiable difference and will have an effect. That might be true with regard to some of the things about Ireland, too.

Outside those cases that are purely about abuse, factors have to be weighed up. Even if you are in a very mobile business and you want to calculate your tax quite finely, you still face the big problem of there being many countries in the world and that they change their rules and rates all the time. However sophisticated you try to be, such decisions cannot be minutely calculated and mechanistic, because you have to go by feel and a sense of the direction in which things are going. That is why countries quite often obsess a bit about the headline rates. Rightly or wrongly, they believe that the headline rates represent more of a visible signal than some of the more detailed rules.

10:45

With IR35, we have just imposed on the UK public sector a much stronger anti-avoidance regime to deal with the practice of getting people off payroll and incorporating them. With the demise of the chancellor's attempt to level the self-employment playing field the other way, you might, if you got out your crystal ball, suspect that that anti-avoidance regime will be rolled out before long, at least to the larger private companies. After all, what UK Government is going to allow an erosion of the tax base without doing anything about it?

As an institute whose members are tax advisers, we do not take a political position on whether there should be a differential between the employed and the self-employed in the tax system, but we would say that if you wanted to have a differential, you ought to have a much clearer set of rules, even if it makes things slightly complicated. It might, for example, take the form of a decision tree.

Part of the problem at the moment is the extent to which things are based on case law. It depends on a variety of factors and circumstances, but it is very easy for an employer to convince himself that somebody could be classified as self-employed because there are so few hard-and-fast rules. The cases go different ways. If there is a desire to maintain a differential in the long term, it would help if the position were a lot clearer.

The Convener: Did you want to comment, Richard?

Professor Murphy: Where do you start on this one?

Charlotte Barbour: I will follow you.

Professor Murphy: I would suggest that, in considering this question, we need to stand back. We are dealing with a beast that is wholly unsuited to the modern world. The limited company was not designed for the 21st century; it was designed in the 19th century, when there was separation of capital and management. There were meant to be distinct rules that governed the conduct of directors, and they were accountable to the shareholders, who were not the same people. It was never envisaged that there would be a company that consisted of one person who was simultaneously shareholder, director and sole creator of value. That was not the beast that was created in the 19th century—it is a beast that the UK is pretty much responsible for creating.

We need a form of incorporation that is suitable for business in the 21st century. Scotland has some distinct and separate forms of incorporation, such as the Scottish limited partnership, although at the moment that is probably best known for being abused. Scotland could consider whether a suitable beast could be created that would encourage enterprise but which would be significantly less open to tax abuse. The obvious way to do that would be to create a larger company for those businesses that require a certain degree of capital intensity and which might therefore still be subject to corporation tax, but there could also be a smaller company that would provide the protection of limited liability—the separate entity principle, which allows it to contract in its own right—while being, with regard to taxation, a see-through entity, as a limited liability partnership is, so that the profits would automatically be attributed to the members and would be taxed as income tax. That would mean that there was no arbitrage available between corporation tax, national insurance and income tax.

We know that LLPs have been abused because offshore companies that have incorporated in the UK have used them extensively to avoid paying tax in this country while appearing to be UK entities. There would have to be some withholding tax to prevent overseas abuse of such a structure, but Scotland could consider whether such an innovation is possible and whether a new hybrid-style entity could be developed that would encourage enterprise, be fully accountable and put its accounts on public record, but which would also provide a degree of tax neutrality that would stop the game playing that is largely for the benefit of the accountancy profession.

Ivan McKee: Would that be possible within the devolved settlement?

Professor Murphy: I am not entirely sure that it is possible at the moment. I presume that devolved settlements are always subject to negotiation. I am sorry, but I think that everything in life is up for negotiation.

The Convener: If only it were that simple.

Charlotte Barbour: Going back to the devolved tax powers and looking at income tax, we can, to go back to my earlier point, overemphasise the point about people incorporating, because, as has rightly been said, it is just not that easy just to step out of employment and become self-employed or a company. The issue needs to be kept in perspective, and we also need to keep in perspective the fact that a lot of our higher-paid people are in the public sector, so they are the least likely to be able to do such tax planning. We have to be careful here.

We also need to be mindful of the fact that companies do not automatically equal good or bad; there are various forms to think about. For example, the Office of Tax Simplification has said that around 10 per cent of businesses are partnerships. They are a really sound form of business, and perhaps there should be a stronger emphasis on some of those with regard to self-employment.

Last but not least, coming back to the conversation that we have just had, I would say that some, though not all, of our members would question the lowering of corporation tax rates. On the other hand, most of our members would emphasise the point that companies contribute a lot in other taxes—for example, through employment taxes or through the collection of VAT and national insurance—and we should not forget that if we want to encourage businesses to set up here.

The Convener: Okay. We have covered a lot of that area in our discussion. I think that Adam Tomkins wants to explore issues around the gig economy.

Adam Tomkins: I want to ask the witnesses about the relationship between tax, our powers in the Scottish Parliament—a number of things that Mr Murphy has talked about do not fall within the Scottish Parliament's competence—and the nature of the employment market in Scotland. As politicians and policy makers, we hear a lot about the changing nature of the employment market and the rise of the gig economy, and I wonder whether one of you can put your finger on and define the label "gig economy", as I am not sure that it is being used consistently or even coherently.

I also want to pick up on a number of things that Charlotte Barbour has said. I think that it is still the case that 85 per cent or thereabouts of workers in the UK generally and Scotland specifically are employees. Is that the right balance for the economy? If not, should we seek to increase or decrease that percentage? If we should seek to change it, what can we do within our competence to try to encourage or facilitate that? Should we make it easier or more difficult for people to move from employed to self-employed status? It seems to me that the picture that the panel is painting is not entirely clear on that.

First, though, what is the relationship between the tax powers that we have and the nature of the employment market in Scotland at the moment? Perhaps we can start with Charlotte Barbour.

Charlotte Barbour: What I would say for starters is that ICAS would not necessarily comment on whether one should push more towards employment or self-employment. Our remit is primarily to look at the operational aspects of taxes and how they work.

I quite like the way that the OTS and the Institute for Fiscal Studies have tried to analyse the gig economy. One of the difficulties with the sector is that there are rights for employees under employment law, and the tax law on employment and self-employment is different. It is about how the bits fall in the middle.

With the gig economy, there are, to my way of thinking, employees, completely self-employed people and folk who fall somewhere in the middle—quasi-employees, such as Uber taxi drivers, who are quite difficult to shunt one way or the other. The Taylor review is looking at that, and it will be interesting to see what comes of that. I hope that it will help set the direction of travel for teasing those things out.

As for tax powers, because we have only income tax powers, we are looking primarily at employees, and a question for members is whether they want to use those tax powers to try to retain employment because that is the easiest way of picking up income tax—through PAYE, for instance, and from 85 per cent of the population—or whether they see tax as just one element and hopefully things will pan out.

Professor Murphy: I am not entirely sure that all the things that I have talked about do not fall within the scope of the Parliament. It should be remembered that it is responsible for income tax, and I am suggesting ways in which you can identify those who might pay that. Revenue Scotland clearly has a relationship with and a responsibility to the Scottish Government with regard to collecting the tax that is owed under income tax rules in Scotland.

Charlotte Barbour: It does not.

Professor Murphy: I am sorry—I am being corrected on that.

Adam Tomkins: HMRC collects income tax. Revenue Scotland is responsible for taxes that are devolved in full.

Professor Murphy: I am sorry. However, there is still a dialogue to be had about the taxes that are collected on behalf of the Scottish Government where it has the right to make decisions on the taxes that are due. In my experience, a lot of taxation is based on soft negotiation, not hard legislation. All four of us at this end of the table will be used to having regular meetings that could be described as soft discussions about how the tax system should work and which do not actually result in legislation or anything else.

In the area of the gig economy, you have the power to make representations on how you want things to be managed to ensure that income tax is paid. You should be encouraging people to adopt the right form, and Scotland should try to make sure that, where self-employment is the right thing for somebody, they can pursue it as a self-employed person, a partnership, a company or, indeed, other forms of company that might, in due course, be allowed.

You should also encourage HMRC to make sure that it collects income tax on behalf of the Scottish Government where it is due. That seems to me to be incredibly important. If that is a lever that you are using as part of Scottish policy, ensuring that HMRC uses its powers for that purpose seems to me to be a fundamental part of the duty. That does not require devolved powers—it requires discussion and bringing pressure to bear.

Charlotte Barbour: I definitely second the suggestion that, given that the gig economy is a UK issue and given how all the different taxes converge, it would, for the sake of policy here, be helpful if Scottish Government officials, Revenue Scotland and everybody else continued to work as closely as possible with HMRC. However, they probably do that anyway.

Adam Tomkins: That is the evidence that we have had so far. Did you want to come in on that, too, Alex?

Alex Cobham: Yes. I want to make a point about incorporation and a point about tax. On incorporation, Ivan McKee and Richard Murphy earlier raised the origins of incorporation as a means of spurring entrepreneurship by providing limited liability. However, the quid pro quo was always that accounts would be published to guarantee that those whose liability was allowed to be limited and who were getting that benefit were also accountable to other people operating in the market—suppliers, customers and so on. The transparency of their accounts provided some guarantee of that, and there is a risk that, through bad enforcement and other forms of incorporation, that quid pro quo will be allowed to fade away. That would undermine the efficiency of the market, because we have some actors within the market who do not face the same accountability as others.

However, the gig economy takes us to the other side of things. On that, I very much agree with Richard Murphy that the corporate entity, as we would think of it, is not really structured for such an economy. Instead of thinking about how people might be using companies to avoid accountabilities of one sort or another, we need to think about how companies are being used to impose a worse settlement on the people doing the work through that company. That type of accountability problem is very different from the one that was originally considered and addressed through the creation of limited liability. A lot of that goes well beyond what this Parliament is able to take action on, but the issue is worth bearing in mind.

On the tax point, there is abundant evidence that paying tax is a social, not an economically rational act. For every type of tax that you might look at, people in every jurisdiction pay more than they should, if we consider that people decide how much tax to pay on the basis of whether they will get caught and how much they will have to pay if they do get caught. People consistently pay well beyond that, because they take part in tax as a social act.

What that means, among other things, is that there is a power in the Scottish Parliament, well beyond the devolution settlement, with regard to the positions that you express about the social acceptability of particular tax behaviour. In particular, you might want to consider the positions that you stress about the appropriate—or otherwise—use of incorporation in different ways. To an extent, at least, you might expect that to have an impact beyond any legal power that you might actually have to back it up, because such statements are expressions of social acceptability—and they do influence behaviour.

Professor Murphy: I agree.

Charlotte Barbour: I agree, too.

11:00

John Cullinane: On the gig economy, if more people in society genuinely want to be their own boss and are happy to take the risks that Richard Murphy has mentioned, either because they think that they can make more money by building up a business or because of a lifestyle choice that means that they can take time off when they want to, it is not the job of the tax system to say that that is a bad thing. It is the tax system's job to accommodate it. The tax issue might come in if, as a matter of fact, doing things that way is—rightly or wrongly—more lightly taxed than employment, and the policy makers have to say that the money has to be made up somehow. We suggest that some kind of public debate about that would be the best way forward.

The other point relates to when there is no real dramatic change in a person's underlying lifestyle but they are, under pressure from the employer, being shoehorned into that sort of structure. Arguably, that situation is more abusive, and policy makers are unlikely to just sit there and say that they accept the tax that is being paid as a result. The tax system has to react to social pressures.

Adam Tomkins: That is helpful. Thank you.

The Convener: We have had a wide-ranging discussion. Willie Coffey wants to ask about what this all means for the Scottish block and the fiscal framework, and what it means for the amount of money that Scotland is going to spend. We really need to get some of that on the record. If we can tease some of that out, I will come back to others to cover the areas that they want to talk about.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): Richard Murphy and John Cullinane mentioned the imbalance in the powers that Scotland does and does not have. John talked about powers being on one side of the equation and not the other, and Richard talked about being exposed to a small part of the system about which we can do very little, and how we should get back to the negotiation table. What are your views of the fiscal framework in that regard? Does it provide any counterbalance for Scotland in which adjustments might need to be made? Is it strong enough to be genuine or do we need to renegotiate the arrangement?

The Convener: I have a wee bit to add to that wider question. It strikes me that there is a difference between the number of incorporated self-employed people in Scotland and the number in the UK, so what impact might that have on the block grant? If you have looked at that issue, it would be useful for us to hear your views because, at the end of the day, it might mean that we have less or more money to spend than we expected. When you are dealing with Willie Coffey's question, it would be useful if you could pick up that point.

Charlotte Barbour: Are you asking about the no-detriment element?

Willie Coffey: Yes.

Charlotte Barbour: Richard Murphy might also want to pick this up. When it comes to accountability, the transparency of the fiscal framework and being able to see what goes in and how it gets mooshed around and comes back out as no detriment, it is quite difficult to quantify how much stems directly from Scottish policy and how much stems from UK policy. I am picking up that that will prove to be quite difficult.

Willie Coffey: Do you see any mechanisms in the framework that will attempt to deal with that?

Charlotte Barbour: I have not investigated the actual machinations of the calculations.

John Cullinane: Our members are tax advisers for tax issues at the nitty-gritty, day-to-day level. That is where the institute's expertise lies. We are not constitutional experts, to be frank. I tend to think that no system is going to be perfect. If you had complete powers over the whole tax system, you would still have to react to the kind of decisions that neighbouring countries and jurisdictions make, because behavioural effects cross borders. Equally, if nothing was devolved, that would probably not be perfect either. There would be no responsiveness to local Scottish concerns. Nothing will be perfect, but my impression is that an attempt has been made with the relatively new powers in Scotland to have more of a debate about the way forward.

Part of the problem is the historical lack of consultation and the springing of surprises at UK level. After all, until recently, the UK level has had complete powers over virtually the whole tax system—the EU limitations are really quite limited—yet we have allowed big imbalances to develop. Partly, that is because the system has got a little more complicated and because there is a tradition of surprises being sprung on budget day. The decisions are all made by a limited number of people who might be experts but who clearly do not see all the ramifications, because of the secrecy and the hurried nature of their deliberations. We have even allowed those imbalances to develop in a system in which there is complete control over more or less everything.

More debate at the various different levels must be encouraged, and there must be an attempt to ensure that there is a more consistent sense of direction, rather than it being simply reactive.

Charlotte Barbour: If you wanted to do that, you would need to start by having a much broader public information programme. I speak to people about Scottish taxes and, like Richard Murphy—who wrote “The Joy of Tax”—I find it all very exciting, but I am in a minority, because most people say, “Scottish taxes? On ye go, Charlotte.” However, we have a really interesting set of different powers that have been devolved. Income tax in Scotland is a version of the block grant, in many respects, and you will not change that radically, but then there are the properly devolved taxes, such as LBTT and the landfill tax, and there is quite a lot that can be done with them. Further, there is a capacity to make new taxes, and there could be some imaginative thinking around that.

If we were to start explaining all that to people and discussing the various elements with them, we would take our debates a lot further, and issues around the fiscal framework would start to filter through in a way that would enable people to ask how the system works and to find out more about the issue of no detriment. In itself, the issue of no detriment is interesting because, if you took it to the nth degree, you would not devolve the powers, would you?

Willie Coffey: Quite a substantial surprise was sprung yesterday in that regard, as well.

Richard Murphy, why do we need to go back to the negotiating table on this issue? Does it matter if there is such an imbalance in the powers that we have?

Professor Murphy: There are extraordinary imbalances in the relationship. A few weeks ago, for better or worse, I wrote a blog post about the “Government Expenditure and Revenue Scotland” figures, for which my Twitter timeline is still suffering. I can assure you that I have never come across anywhere that is more interested in national income accounting than Scotland is. You have turned it into a national obsession, it seems. I was a little surprised by the reaction, so I walk with a little trepidation, knowing that someone, somewhere, will have a lot to say about what follows.

The simple fact is that the amount that is known about Scottish taxation is very little indeed. Let us put it bluntly: inside GERS, 25 of the 26 income figures are estimates. Graeme Roy of the Fraser of Allander institute, who was responsible for preparing GERS for seven years, has said that the figures are prepared on the basis that Scotland is a mini part of the UK, and the figures are simply apportionment of the figures for the UK as a whole. In other words, Scotland is not an independent entity. However, I am sitting in what appears to be the Scottish Parliament, which is a clear recognition of the fact that Scotland has some independence as an entity. Scotland is being given devolved taxation powers but is not being given the data on which to make decisions. That is the core argument that I presented.

However you look at GERS—and, yes, I am quite sure that those who are tasked with preparing the figures do so in good faith and with due diligence in terms of the data that they get from the Office for National Statistics and elsewhere—nobody would ever prepare the income statement for a region, a devolved country’s Administration or whatever else on the basis of samples and statistics if it was possible to actually collect the population data. In statistical terms, you always want to know the real figure, not the statistical estimate of what that might be. If the GERS statement was a good basis for estimating Scottish taxation income, the UK would use that system, but I assure you that it does not—it actually uses the data on the amount of tax collected, which is the obvious direction of travel.

If Scotland is going to get a fair deal on tax, under whatever system exists and however it is framed, whatever the rules are on detriment and so on, Scotland needs the data to enable it to make decisions and to see how those issues impact upon it. It is no good just having information on income tax from employment, which is the one area where there now looks to be a reasonable chance of the quality of data improving. As we are seeing, what is going on is an arbitrage between one tax and another: between taxes that will be subject to Scottish rates and taxes that will not, such as national insurance, corporation tax and so on. Also, whether you have Scottish-registered businesses or not, who knows whether that will have an impact on the VAT collected in Scotland? It quite easily could, because if there is no business in Scotland, there will be less VAT charged as such on a differentiated business framework in Scotland, and that will have an impact.

One of the things that Scotland needs to do if it is going to get the framework right is to say "For heaven's sake, can we have the real information?" I would not make that request just for Scotland—I think that Wales and Northern Ireland need it too. Scotland should co-operate with colleagues in other Parliaments and Assemblies for that reason. Indeed, I cannot actually see why the new mayor of Manchester will not want that information if he is going to ask for taxing powers—I am being gender specific because it is going to be a he—or why London would not want it. The data should be collected.

Scotland definitely needs that data because of its taxing powers, and at the moment we simply do not have the right information. I teach my students about the quality of data that they are going to interpret and how to look at whether it is good information or not. The term that I use is CRAP, which is a technical term that stands for "completely rubbish approximations", and that is what you get to assess your tax system at present.

Willie Coffey: Thanks.

Professor Murphy: My students remember that.

Alex Cobham: On a broader point, although I am not wanting to join in the fun of Richard Murphy's Twitter timeline, I will add that, internationally, it is very clear that control of data is associated with the strength of fiscal decentralisation. At the extreme there is somewhere like Sudan, where I was apparently persona non grata for a while after doing research using their regional state data, because it demonstrated a deliberate decision to exacerbate inequalities. The data had been kept hidden nationally until we took it from the International Monetary Fund and republished it in Sudan.

That is not say that Scotland is in that position, but it is worth saying that the relationship broadly exists. From both experimental and actual evidence, the two things on which the willingness of people to pay tax rests fairly consistently are the sense that other people are paying their taxes and the sense that those taxes are being redistributed effectively. If people do not have confidence in the data about where money is coming from into Scotland or about where it is being spent—how inequalities here might compare with those in the rest of the UK, or the entirety of that process—over time that will erode rather than strengthen the relationship between state and citizen and therefore erode the likelihood of people paying tax as a social act. This is not just an argument that takes place on Twitter about some technical accounting issues; the data issue is fundamental to the politics and social engagement.

Patrick Harvie (Glasgow) (Green): Where shall I begin? Joining the conversation after this long means that there has been an incredible breadth of coverage. In my view, the strongest evidence that we have had so far from this panel is that we are a very long way from having either a taxation system or a company law system that meets the aims that I think that most of us would subscribe to—those of sharing the wealth of the economy properly while ensuring that there are adequate revenues for public services.

We are not going to fix that in this committee meeting. We are not going to fix it unilaterally at the moment. It may be that, one day, this Parliament will be in a position to make many more decisions about the matter and to have a negotiation with the UK Government without being told that now is not the time to resolve some of those questions. However, given where we are right now, I am keen that we focus on some specific actions that this Parliament might be able to recommend in relation to some of the problems.

11:15

We may have to ask about this and test it, but let us assume that there is broad policy agreement from the Scottish Government that the phenomenon of people incorporating specifically to move what most people would regard as their income out of income tax and into corporation tax is a bad thing that should be tackled and reduced.

Do any of you have any information about the scope of the Scottish devolved public sector—the Scottish Government, local government, health boards and public agencies—that the Scottish Government is responsible for in relation to either its direct employment arrangements or the contractors and private sector organisations that it has relationships with? In relation to procurement, what is the scope for using the current powers of the devolved Government to limit or eradicate such practices, or, indeed—as I think Alex Cobham was talking about—to stigmatise them further and create additional disincentives to that behaviour? Can you recommend any specific actions that we could take right now?

Charlotte Barbour: That is an interesting approach. Tax should be part of your wider policies and it is just one element—you are absolutely right that other elements sit with it. If we look at the powers that you have here and now and at a Scottish approach to taxation, you can usefully build a bigger picture and take a positive approach to taxation by setting out broad principles that you might want to follow over the course of the parliamentary session—a road map for how you would like to go about things.

I completely agree with Alex Cobham that there can be far wider messages about whether you do or do not want tax avoidance. That came through quite strongly when the Revenue Scotland and Tax Powers Act 2014 was going through Parliament, with the idea of having a general anti-avoidance rule rather than an abuse rule, and making it slightly broader. That type of messaging can help.

John Cullinane: I know that this sounds a bit wet, but I think that public debates and indicating a sense of direction are quite important. Certainly, when we surveyed our members for their input to the original evidence that we gave, there was quite a strong emphasis on stability and simplicity, if possible, and a sense of direction.

In the UK tradition, which Scotland is in a way part of and has inherited, we tend to get these suddenly announced changes and each change tends to make for a more complicated system. If it is an adjustment on employment or self-employment, people do not know whether that is the end of the agenda or whether it signals new things.

If the Government at least tried to give some broad indications of where it was trying to take the devolved powers over time, as and when resources permitted, so that there was a clearer sense of direction, it would enable people to understand where they were, to some extent.

That would affect behaviours as well. For example, if people got the sense that, over time, the policy was to try to get a more level playing field between incorporation and non-incorporation—if that was to be your policy—I think that you would find that, even with nothing else changing, there would be fewer tax-motivated incorporations because people would be less inclined to go through a lot of hoops for something that might have a limited shelf life.

Patrick Harvie: That is a useful phrase—"go through a lot of hoops". Can we put more hoops in place? Can we make it a more difficult process to go through or put more disincentives in the way of that behaviour?

John Cullinane: One of the issues is that, although you have power over the Scottish rate of income tax, that does not extend to some of the detailed rules, which makes things quite difficult.

I think that adopting a more consultative debating approach would have a knock-on effect at the UK level because there is a growing body of opinion that the tradition of secrecy and surprise has gone too far and is not serving any purpose. Even when you needed some kind of co-operation or change or whatever at the UK level, if you gave a sense of what direction you were trying to take things in, it would be helpful to you and probably to the rest of the UK.

Professor Murphy: There are a number of areas where some quite specific actions can be taken. I confess that I have not read the rules for a couple of years but Scotland has quite different rules on procurement from the rest of the UK. The way in which taxation is built into the rules on Government procurement in Scotland is different from the way that that is done in the rest of the UK, as I recall it—it is more specific. Tax is to be considered as a factor in procurement more specifically than it has been for UK local authorities, for example.

That is a route where some action could be taken. The current indication is that people are willing to discriminate in procurement only where there is a clear sign of abuse. That might be a referral under the general anti-abuse rule, whether for the UK as a whole or for Scotland, or some form of sanction that has been imposed. Those are very high-level hurdles to jump over, because nobody has ever been referred under the UK GAAR rules, so that is a meaningless test at the moment, frankly. It has existed since 2013 and has never been used, so that cannot be the criterion, but there could be other criteria.

Since 6 April, we have had the new IR35 rules, which will apply to public sector bodies hiring people who are on disguised employment contracts. You could say that nobody from the private sector can be employed to substitute for a public sector service if they are using arrangements that would not be acceptable in the public sector for taxation purposes, obtaining an unfair competitive advantage as a result, purely by exploiting the tax system. That is an entirely possible thing for Scotland to consider doing, and it is within your powers.

Patrick Harvie: Are you suggesting that it could be built into the public procurement process?

Professor Murphy: It could be in the public procurement process.

I also want to mention something slightly softer. The largest company to have a fair tax mark—I should disclose that I am a director of Fair Tax Mark—is a Scottish company, SSE, which has been a pioneer in talking about tax responsibility and has done a good job in promoting publicity around its tax affairs. The Scottish Government could consider how it could encourage other companies to follow SSE's example; to improve the quality of their disclosure; to disclose what they are paying, how, when, where and why; and to show that they are paying their tax in Scotland.

Patrick Harvie: I might ask Alex Cobham to respond to this, because he was talking about the social values attached to tax. One option would involve the Scottish Government's business pledge, which is intended to promote ethical behaviour around the living wage and other factors such as promoting gender diversity and not exploiting younger workers. There are clearly areas where that kind of pledge could go further and could become a precondition to accessing state-funded forms of business support services. Could we add in a tax ethics aspect to that kind of measure?

Alex Cobham: That makes a lot of sense, but we have talked about debate and about changing rules and, at the risk of coming over all Tony Blair, I think that there is a third way through the middle of this. Pledges and debates take you so far, but rule changes are harder to achieve. In the middle is the data.

I was thinking what a good question you asked, but then I realised that it is actually a slightly shocking question. It is a good question for me to ask. You could go to all the public bodies with freedom of information requests and start putting together the information, but from your side of the table it seems like a shocking question.

Patrick Harvie: Why do we not know this already?

Alex Cobham: Exactly. Having data in the public domain from every Scottish public body on the proportion of their spending that goes through certain types of structures, or the proportion of their procurement spending that goes to companies with the fair tax mark, whether you do it yourselves or you allow civil society to put together the rankings, could start to put pressure on those at the extremes. It seems that that does not involve the difficulty of making hard rules, but it is much more likely than discussion alone to drive behavioural change, and if that information is not available to you now it should be, and it should be available to everyone else.

Patrick Harvie: That is very helpful. Thank you.

The Convener: If there are no further supplementaries on that point, I will call Ash Denham, who has some wider questions.

Ash Denham (Edinburgh Eastern) (SNP): This morning's discussion has been very interesting and I thank the panel for their comments. My question is about Richard Murphy's suggestion in "The Principles of Scottish Taxation" that the Scottish principles might be "insufficient". I would appreciate your thoughts on that.

You also refer to Scotland's current tax powers, Professor Murphy, and you describe them as "largely symbolic" and potentially "booby-trapped". Can you explain what you mean by that?

Professor Murphy: I have a feeling that my Twitter timeline is about to explode again.

Ash Denham: Sorry.

Professor Murphy: That is all right; that's life.

I was concerned about the suggestion that we go back to 1776 and we use Adam Smith as the basis of the principles for Scottish taxation. He was a good Scottish moral philosopher and, at the time, he would not have recognised the term "economist". However, he did not know about most of the taxes that we are talking about. The tax system of Adam Smith's time was fundamentally different and his understanding of tax is, I suggest, out of date.

I argue for something called modern taxation theory, and I think it is fair to say that Alex Cobham is broadly in the same space. The theory argues that taxation has a large social and macroeconomic role as well as its purely technical function of raising revenue. I actually argue that it does not even raise revenue but that is a secondary issue that we will leave aside at the moment. The tax system therefore has to reflect its true social function, as Alex Cobham and I have been saying regularly.

I am not in any way arguing with colleagues from professional institutes who are looking at the technical aspects of tax, but tax is much bigger than that. Reasons for tax include redistribution and repricing market failure. Those are really important reasons, as is raising representation in a democracy. People who pay income tax actually vote. If you are interested in engaging people in the political process, taking people out of paying tax is not the right way to go. That is rather bizarre but, nevertheless, it is certainly true.

For that reason, I suggested that the four proposed bases are not sufficient for Scotland. Tax is a part of the management of an economy, so you have to put it fair and square into macroeconomic policy. Most of the considerations of efficiency certainty, which is a deeply ambiguous word, as Alex Cobham explored in his submission, are too micro focused. We have to talk about what the Government is trying to achieve, what its social and economic policy is, and how tax can help to implement that. The whole thesis of my book "The Joy of Tax" is that tax is the tool that has the greatest power that is available to a Government to change the shape of society. The principles should therefore do that.

My next suggestion is that the system should reflect the priorities of the Scottish people rather than anything technical. It should encourage the engagement of people in the democratic process, which is why I was talking about data and the availability of data to encourage people to understand the process of government of which they are a part, and in which they need to be encouraged to play their part.

I felt that those were important points to make before we came down to talking about more mundane things such as minimising the opportunities for abuse and so on. I read much of the evidence that was submitted to the committee in the autumn of last year and a lot of it entirely missed those points. The evidence that was provided was not about the foundations of Scottish taxation and was not about principles; it was about administrative tools and how they can be structured, but that is some way operationally after the strategic goals and foundation principles for the tax system. To me, that was quite critical.

Having said all that, I have completely forgotten what the second part of the question was; I am terribly sorry.

Ash Denham: It was about the largely symbolic nature of the income tax measure that has been devolved.

Professor Murphy: When a small number of tools is devolved, you have to look at the decision that is being made by the person devolving them to see whether they are setting up the person who is being given the responsibility to succeed or fail. That is what I would say if I was looking at a business. I have seen managers in businesses who have devolved a responsibility to members of staff who can only fail as a result of making any decision that they have been given to make. They have been booby-trapped.

Has Scotland been booby-trapped by being given a limited range of powers? My answer is yes. If you are trying to create a fair tax system, you cannot do that by changing the tax system to one that relies on income from earnings alone. We only have to look at incorporation to realise that. How daft is it that a person who has incorporated their business in Scotland can decide for themselves whether they are within the Scottish or the UK income tax system by deciding whether to pay themselves by way of salary or by way of dividend? One is within the Scottish rate system and one is without.

That is a booby trap because it might immediately encourage some people who do not like the Scottish devolved situation to choose to incorporate and pay dividends simply to deny the devolved Government a source of income. There is some evidence in academic research of that happening, by the way. It is clear that that happens in the States. The tax gap increases in states that have the opposite view from that of the federal Government that is in power. If a state is Republican, it will have a higher non-compliance rate when there is a Democratic President, and maybe vice versa—I say “maybe” because more Democrats tend to pay employment taxes than tend to be self-employed. There is certainly clear evidence of a political process even in tax payment.

11:30

The decision to give a tiny range of powers to Scotland therefore leaves it with a very limited range of choices. I am not saying that £400 a year is symbolic—it is not; it is real—but it is a relatively small part of the overall tax liability of those who pay it, and it creates the potential for a significant backlash and political furore where, frankly, very little is really due.

I therefore thought that that provision of powers tinkered at the edges of the system, when what was required was the right to ask deep and fundamental questions about how Scotland wants to create a tax system that really reflects its social priorities, which I do not perceive to be necessarily the same as those of the UK as a whole. That is probably true. I am here quite often, and I realise that Scotland is different; it is not the same as London, for example. In that sense, the powers that were granted do not let Scotland achieve that result, and that is why I called them “booby-trapped”.

Ash Denham: May I ask a follow-up question?

The Convener: Does anybody else want to reflect on the first set of questions before Ash Denham asks a follow-up question? I see that no one does. On you go, Ash.

Ash Denham: You go on to say that

“a much broader range of taxes must be devolved to Scotland”,

and you also mention that Scotland should benefit from quantitative easing issuance. Will you explain that?

Professor Murphy: One of the problems that the Scottish Government has, of course, is that it is required by the rules that exist to effectively create a balanced budget. That constraint does not exist for the UK Government. It can borrow, but we now know that it does not have to borrow, as it can cancel its own debt. It is not widely recognised that QE cancels debt, but it does, and the evidence of that is very clearly available. Members should just go and look at the whole of the UK Government accounts. They will then discover that UK Government debt is not, in fact, some £1.7 trillion or so at present—that figure is regularly rolled out in news bulletins; it is £435 billion less than that because the debt has been cancelled by QE. For example, although it is expected that the final figure for borrowing by the UK Government will be £51 billion for the past year, £60 billion of debt will have been cancelled under QE. Therefore, overall UK Government indebtedness last year fell even though there was a deficit. Scotland is not in that position, because none of that QE capacity is devolved to it, but the benefit could be considerable.

I am well aware that Jeremy Corbyn once borrowed that idea, but he did not use it for very long. He called that "people's QE". I make it clear that I did not write that for him; he borrowed that idea, and I was quite happy for him to do so. The idea was to use QE as a proactive measure to provide an investment fund to ensure that there could be a long-term infrastructure programme to develop the economies of the UK, Scotland and others. I do not see why Scotland could not go to the UK Government and say, "Hey, hang on a minute: £435 billion. Even if we just apportion that on the basis of headcount, that is a mighty lot of money that could have been given to Scotland to provide a fund for investment in this country, which we have not had available to us." That is a soft discussion. That is not within the devolved powers, and that is not being discussed by anybody else, either, but that is the sort of issue that needs to be on the table, as it is part of the whole macroeconomic debate.

Tax does not exist in isolation within the macro economy. Taxation, money issuing and QE are all fundamentally related subjects that are completely and utterly incapable of being considered in isolation. If you are considering tax, you have to consider the right to cancel debt, which is a substitute for tax in terms of the means of payment. Therefore, Scotland has to demand that QE be on the agenda, and the right to have the benefit from QE has to be devolved to the Scottish Parliament.

Ash Denham: Thank you.

The Convener: Does anybody else have any final supplementary questions before we wind up the session?

Liam Kerr (North East Scotland) (Con): I do not really have a supplementary, convener; I just have some questions around the subject.

An awful lot is based on perception. There seems to be an underlying perception in some of the papers, and indeed in some of what we have heard today, that people incorporate for reasons of tax planning or tax avoidance. Some of the terms that have been used, such as "abuse", "social acceptability", "a bad thing" and "tax ethics" betray that underlying perception. Has any breakdown or analysis been done of how many limited company contractors are incorporating for tax planning reasons, as against those who are incorporating because it is the best way to sell their skill set? How many are doing it for tax avoidance reasons and how many because it is the right way to model their skill set or their business?

John Cullinane: There are quite a lot of studies on that. The Office of Tax Simplification has studied it quite a lot, and the OBR has looked at the problem of the erosion of the tax base historically and the likelihood of that continuing.

It is difficult, even theoretically, to draw the line between what is tax motivated and what is not, because in a typical case there is a mixture of motives and considerations. If we could get inside people's heads and measure exactly what they were thinking, we would probably find that it was a bit of a mixture. I am not sure how easy it will ever be to take things a step further and answer that specific question.

Charlotte Barbour: Judith Freedman from the Oxford business school has done a lot of analysis of the issue. There are a lot of sources on it, and the House of Commons Treasury Committee is running an inquiry that includes elements of it. It is obviously an issue that a lot of people are thinking about.

Part of the solution is to work on a UK basis, because it is a UK issue. I do not think that we can say that somebody has incorporated purely for tax purposes. As accountants, when we advise folk, we have a checklist that covers limited liability. Many people would prefer to be a managing director rather than just Charlotte Barbour, for example. A raft of factors are weighed up. Tax is an important element because it has a specific cost. On the other hand, there are a raft of reasons for not incorporating, such as not having to do separate accounts and the fact that, once someone's money goes into a company, they can have difficulty getting it back out because the company will be a separate legal entity. There are a lot of factors.

Liam Kerr: I accept that, and I am grateful for that answer. Is that not the fundamental data that is required? Before we say that the number of people who are incorporating is a bad thing and that the Government must do something to remodel how the outcome presents itself, surely we should establish data that tells us what proportion of people incorporate for tax reasons—to avoid or pay less tax—and, to return to Ivan McKee's point, what proportion are doing it for good economic reasons that drive a particular economy.

Charlotte Barbour: The studies that are being undertaken attempt to tease that out. There are two elements to the issue. One involves people who might be pushed out of employment because of the national insurance contribution costs. I think that we generally accept in broad terms that it is not a good thing to force people in personal service companies—IR35 companies—into incorporation, because that is often largely tax driven and it might negate some of the benefits that they have as employees. People tend to see that as a bad thing.

The other kind of incorporation involves people who run proper businesses that make widgets, employ people, have a factory or office and all that stuff. For those people, the decision will never be purely about tax but will be much wider. Incorporation might be a good thing if a business is a certain size.

One of the interesting things in the OTS study on partnership is that people forget what a lot of strengths there are in other types of vehicle. There has been a drive towards incorporation, but that comes from the Government, too. When Gordon Brown instituted a zero rate of corporation tax, it sent out a certain signal. There are some reliefs that people get only if they incorporate, and that sends out signals, too. The picture is quite complex.

Liam Kerr: That is right—it is nuanced. A number of the witnesses have made points about people who would otherwise be employees being pushed out and being forced to incorporate because an employer has decided that it wants to strip out overheads, for example. Is there any data that shows how many of those who would otherwise be employees have been forced by employers to incorporate? I am not persuaded that such data is there.

Professor Murphy: I do not think that it is there. In fact, I know that it is not. We cannot be sure of that, although there is quite an easy way to collect the data, and I have proposed several times that we do that. To be frank, I am not sure why we are not willing to make a change towards collecting that data.

It is very simple. On corporation tax returns and self-employed persons' tax returns, you ask the taxpayer to disclose their turnover by their top 10 clients, customers or whatever. If you discover that 99 per cent of the turnover relates to one customer, it is highly likely that there is disguised employment. In such a case, it is obvious. If you discover that 99 per cent of it relates to one customer for four months and to another customer for the next four months, there is a series of disguised employments, but it is still disguised employment. That data could be found easily with just a bit of political will to change the corporation tax return, and we would then know precisely which companies HMRC should target to deal with the issue. We could improve the rate of tax compliance enormously through that one simple change to the tax return. However, that is not being done, so we do not have the data.

Another consequence is that some people who are genuinely self-employed and are taking risks and running a diversified business are being stigmatised by tax rules that are, to be frank, unfair to them. That is another consequence that we must take into account. There are people who sell their skills through a limited liability entity and have a range of customers but, nonetheless, will now potentially be at risk of being penalised as a consequence—for example, when contracting with the public sector.

We need to make that change to collect the data. It comes back to the point that Alex Cobham and I have been making about data, data, data. It is not hard to get; we just have to ask the right questions, which are fairly simple. Actually, the questions signal the behavioural change that we want. We do not want people to incorporate in order to disguise employment. If we ask a question that indicates that they will be found out if they do that, we will discourage that behaviour in the first place. There is a lot of evidence—again, it is mainly from the States—that if we ask for the right information we will, by and large, get the behavioural consequences that we want. That is not entirely the case, because no tax system is perfect, but we will go a long way towards that.

The Convener: Alex Cobham and John Cullinane also want to comment on that.

Alex Cobham: I can see why you want to get to a specific division between good and bad incorporation, but I do not think that the world is like that. Richard Murphy has given you some good ideas about how we could go further down that road but, from a policy perspective, we are probably more concerned with the aggregate impact. We do not ban private property because there are burglars, as it were. There is always some abuse in respect of any regulation that we have. On its own, that is not a reason to prevent the possibility, but it goes towards the balance.

There are two aspects to the risk that we have. One is that it undermines a point that Ivan McKee made earlier—that if all incorporation is good, it is a good measure of the economic vitality of a society. The more that we see incorporation for bad reasons, the weaker that relationship becomes and the less confident we are in that measure of growth and the wider benefits of incorporation.

The best numbers on the impact are the ones on tax base erosion from the OBR. As we see consecutive years of multibillion-pound undershoots projected in different forms of tax—particularly income tax—due to incorporation, we do not necessarily need to argue that any incorporation that reduces income tax is a bad thing. However, the further we see incorporation, on its own, being associated with income tax falls rather than with any wider economic growth impact, the more we may think that the quality of incorporation—in the aggregate—is a problem.

We can then look at different types of corporate entity and say that, for example, the Scottish limited partnership is much more likely to be associated with particular forms of abuse because of its lack of transparency and so on, so we can get a bit more granular.

It is probably not helpful to think that you want to talk about sheep and goats here. You ought to think about the overall quality of incorporation in order to understand what your stance as policy makers should be and how you might want to limit it overall, rather than how much you might want to go after individual bad guys, if that makes sense.

11:45

John Cullinane: Even if all incorporation was good incorporation, if the operation of businesses in that way meant that you got less tax of a certain type, it would have to be made up somewhere. There would be an issue at the UK level as to where it should be made up, and an issue at the Scottish level as to whether that solution would work, given the pattern of devolved and non-devolved powers, the block grant and so on. There would be an issue even if it were all good.

I agree with Alex Cobham's comment that it is difficult to segregate 100 per cent good and 100 per cent bad, as there is a bit of a spectrum. I do not think that you will get hard facts, partly because of the definitional problems over what is good and what is bad. However, if you look back at some of the analysis and you see a big spike in company incorporations when there was a zero per cent rate of small company incorporation tax, or if you notice that the trend has accelerated as the corporation tax rate has come down—there has been a promise that it will be reduced further—you can get a feel, which is sometimes as much as you will have on which to base policy. You will rarely have perfect information at any one time.

In any event, there is enough information to say that incorporation is an issue for the tax base and that, to some degree, it is tax motivated and will vary in amount according to what signals there are and what rates are changed.

Liam Kerr: However, that does not make incorporation the wrong thing to do. That is the problem. It seems to me that there is an awful lot of subjective assessment of whether it is a good or a bad thing, and that that is driven by what the ultimate income tax take is, but that is coming at it from the wrong end. Surely the driver should be the right model for the outcome for the economy, be it self-employment, incorporation or employment.

I will ask my final question quickly. Is the solution less to do with what, to my mind, is the very blunt instrument of tax and much more about IR35, which a number of our witnesses have mentioned? On the disguised employment that Richard Murphy talked about, it seems to me that what is being suggested is that the IR35 legislation is not working sufficiently to pick up on what we might call illegitimate or disguised employment. Rather than using the blunt instrument of tax to force a behaviour change, surely we should simply tighten up the IR35 legislation.

Charlotte Barbour: There have been discussions for years about tightening up IR35. We would need a bigger HMRC to police it, if that is what you want to do.

Liam Kerr: Is it the right thing to do?

Charlotte Barbour: If I picked up the earlier part of Liam Kerr's question correctly, he suggested that the issue is not really how we police incorporation or whether tax is directing it, but more that we should be looking at whether there are differences in tax driven by the fact that we have income tax, corporation tax and national insurance at different rates. If we managed to level them out more, there would be no incentive for people to go one way or the other and they could pick the true economic vehicle that they wanted for their business for other reasons.

Professor Murphy: Yes. That is why I suggested that the committee needs to look at having a new type of incorporation for the 21st century. We have the wrong tools available to us. At present, the choices for businesses are simply wrong and we are forcing people into the wrong models.

The Convener: Thank you very much. That brings our session to an end. I am very grateful to our witnesses. We have covered a lot of interesting ground, and there is a lot for us to consider.

Meeting closed at 11:48.

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Published in Edinburgh by the Scottish Parliamentary Corporate Body, the Scottish Parliament, Edinburgh, EH99 1SP

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