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Introduction

This report makes suggestions on how an independent Scotland might create a viable tax system.

The report is split into four sections. The first considers the principles and foundations on which a Scottish tax system should be based. These are social and economic. As a result the human rights on which Scottish tax should be based are considered, as are the economics that underpin a modern understanding of how tax works and fits into the macroeconomic environment.

Second, observations on the political and functional organisation of a Scottish tax system are made. These give attention to both the political and administrative dimensions of this issue and how both will need to be structured if a truly accountable tax system is to be created.

Thirdly, the interaction of the Scottish tax system with those systems from which it will need to draw data to ensure that taxes can be properly charged are discussed to emphasise that tax does not exist in isolation but must be integrated across systems of government.

Fourthly, there is discussion on more detailed aspects of the tax system Scotland will need. This looks at the actual taxes required. This section also looks at the mechanisms required to beat tax abuse, including the necessary accounting and company law required to minimise the chance that this abuse occurs.
The principles and foundations on which a Scottish tax system should be based

Principles

A tax system is based upon mutual trust. An electorate has to believe that its government will impose appropriate taxes and then administer them not just legally but in accordance with the principles of social justice. A government has to trust that its electorate (and those, like companies, who owe tax even though they rightly have no vote) will pay in accordance with the spirit as well as the letter of the law of the country.

This relationship of mutual trust requires that a tax system be based on sound principles that are clearly stated so that all can understand them. Scotland has a long tradition in this area. In 1776 pioneering Scottish economist Adam Smith argued that tax systems need to be equitable, certain, convenient and efficient. Whilst these may have been a sufficient basis on which to establish a tax system at the time that he wrote our understanding of rights and obligations in society has advanced considerably since then and the principles on which a Scottish tax system must be based have to reflect the world we now live in. The result is that Adam Smith’s suggestions are no longer a sufficient basis on which to build a Scottish tax system.

Despite this obvious fact remarkably little has been written about tax and human rights. Indeed, despite the importance of taxation most declarations on human rights, such as the Universal Declaration of Human Rights, makes no reference to the subject, even if Article 29 implies that there is a universal duty of the citizen to the community of which they are a part, which could be interpreted to include an obligation to pay democratically agreed taxes levied upon them. That said, a careful reading of that Declaration suggests that the following principles on which a tax system can be based can be derived from the relevant articles (shown in brackets) of that Declaration:

1. A State has a duty to protect its citizens; (3)

2. A State has a duty to provide public goods for its citizens; (22, 23, 25, 26, 27)

3. A State may not discriminate in the provision of protection or provision for its citizens; (1, 2, 3, 7, 8, 10, 21)

4. The extent of the provision to be supplied by a State shall be determined by democratically elected governments; (21)

5. The right of a State to determine its will shall not be constrained by the actions of another State; (28, 29)

6. A State has the right to levy taxation; (implicit in the obligations imposed in Articles 3, 22, 23, 25, 26, 27 and 28 which could not be achieved if this were not true)
7. Any charge to tax must respect the right to hold private property; (17)

8. The charge to tax must not be arbitrary; (17)

9. Taxation must be imposed by law; (12)

10. All citizens of a State shall be subject to the same taxation laws; (1, 2, 7)

11. Each citizen has the duty to pay the tax due by them; (the corollary of 21 and implicit in 29)

12. The citizen shall have the right to appeal against any charge to tax; (8, 10)

13. The State may only oblige a citizen to disclose that data required by law when requesting information for the purposes of assessing their liability to tax; (12)

14. A citizen shall have the right to leave the State and its protection and shall as such deny themselves the right to its provision but be relieved of the obligation to contribute to its upkeep. (13, 28, 29).

Note that these are principles; nothing in them suggests the form a tax system should take. However, since it is clear from point 3 onwards that the provision of services to an individual exists whatever their capacity to pay, and given that it is always the case that some people will always be unable to pay any or much tax, then by necessity this derivation of rights with regard to taxation must require the use of progressive taxation or the obligations on the state that must arise from the Declaration could not be fulfilled.

It is suggested that these principles derived from human rights should form the basis for Scottish taxation.

**Economic foundations**

If Scotland is to have a sound tax system then it must be based on economic reality. The difficulty in achieving this goal lies in the fact that the real role of tax in the economy and wider society has, until recently, rarely been properly understood. Just as the Bank of England had to say in 2014 that the way in which money is created and in which banking operates had been almost wholly misunderstood by economists and was incorrectly represented in almost all economics text books, so too is tax widely misunderstood. This is because it is widely believed that tax is necessary to pay for government provided services. It has, however, recently been realised that this is not the case. This is because all government services can in principle be paid for either by a central bank creating new money or by quantitative easing (‘QE’) operations (which amount to much the same thing). In theory, therefore, tax is not required for public services to be supplied: they can be funded entirely without cost so long as an economy can absorb the new money that a central bank creates for a central government to pay for them without inflation arising.

The evidence for this is readily available within the UK economy. Between 2009 and 2017 the Bank of England created £435bn of quantitative easing funding which it used to buy bonds issued by the UK Treasury which had, in turn, been used to
The key point is that the Bank of England created the money ‘out of thin air’ and used that money to repurchase government debt that had previously funded government spending. As importantly, the government debt in question is cancelled: the government’s own balance sheet shows that. The net result is that because the government owns the central bank the spending has been paid for with new money that has been created for the purpose, there is no debt as a result, and the taxpayer has not incurred a penny of cost for the government spending that has occurred. The reality is that there is a Magic Money Tree. What is more the choice of name was not made by chance: its abbreviation as MMT is, of course, identical to that of Modern Monetary Theory, from which this explanation of the role of money creation in the macro economy is derived.

There is, it is important to note, nothing magic about this process: it is in fact the way in which all government spending is initially incurred. It is always true that the government has to spend before tax can be paid. That is because unless the government did spend the money that it wants to be the legal tender of a state into existence then there is no way in which that currency would then be available to make payment of the tax that it demands, liability for which is only ever stated in its own currency. This, incidentally, also explains how the promise printed on a bank note – that the central bank promises to pay the bearer on demand the value of the note – is fulfilled in the modern economy. The promise is fulfilled when tax is paid.

So why the reference to ‘magic’ that so money politicians like to make of what happens in the economies for which they are responsible? There are three reasons. First, this system of government control of the tax and monetary system is relatively new, and is not always believed as a result. It only really came into common use when the USA left the gold standard, which backed up the value of money via a fixed rate of exchange to gold, in 1971. Second, it took a long time for people to realise the implications of this change, an understanding of which is only really becoming commonplace now. And thirdly, since 1979 in the UK and 1980 in the USA there has been a dominant political culture that has suggested that government spending must be constrained. If it was widely known that this spending could be funded without the use of tax (the hatred of which was simultaneously fuelled by this culture) then the whole myth on which neoliberal economic thinking is based – which says that states can’t afford too much government spending – may have been shattered. No wonder it was said that there was no such thing as a ‘Magic Money Tree’: the bigger the lie the more likely it is to be believed.

All that being said, the reality is, of course, that no government would want to pay for all government services out of new money being continually pumped, without limit, into the economy. That is because doing so would undoubtedly result in rampant inflation. This fact does not, however, change the principle: that principle is that all government services can be paid for without taxation. This, then, also answers the proverbial ‘chicken and egg’ question of which comes first: is it ‘tax and spend’, or ‘spend and tax’? By now it should be obvious that the correct answer is that there can be no such thing as tax and spend; the only obvious answer to this question is that there is always spend and tax. In other words, governments can always spend to create the public services they think appropriate using new money created for the purpose and it is the role of tax to reclaim that money from the economy to prevent inflation. The answer to the question of ‘how are you going to
find the tax to pay for the spending you plan’, so often posed to politicians, is a simple one: it is to say that it is the spending that creates the capacity to pay the tax in the economy. To put it another way, the spend pays for itself. Appreciation of this fact demands a whole reappraisal of the role of tax in the economy, just as the Bank of England revelation in 2014 that it was lending that created bank deposits and not savings that permitted lending demanded a whole reappraisal of the role of money in the economy.

This understanding is critical to the design of a Scottish tax system. What it demands is that Scotland must have its own currency from the day it becomes independent. This is, of course, the sovereign right of any state. But it is not just a right: it is only by exercising this right that Scotland can be truly independent of any other country. This is because of another critical consequence of the understanding of tax and money already outlined, which is that a country with its own central bank and currency cannot go bankrupt. So long as it issues its debt in its own currency this must always be true. That is because if it does issue its debt in its own currency then it can always repay it by having its central bank create the money required to do so. In that case it can, quite literally, never run out of money. What that means is that if it had its own currency Scotland could not be beholden to anyone, including the bond markets. There is no greater expression of independence than that.

What should also be clear is that a Scottish currency is also essential for the creation of an effective tax policy for an independent Scotland. This is because, as has been explained, if a country has its own currency then there is technically no limit to what a government can achieve. There are, however, two practical constraints. The first is that the government does not try to create more economic activity than the economy can deliver. To put that another way, they must not try to create more than full employment because that is not possible. And the second is that they must tax sufficiently to cancel enough of the money that the government has created through its spending to ensure that its inflation targets are met.

It cannot be stressed enough that this understanding of how the relationship between a government, money and tax really works when a state has its own central bank and its own currency is core to the future prosperity of Scotland. The implications of this understanding are profound.

Firstly, a policy based on this understanding does not require that the Scottish Government balance its budgets. In fact, if it is to inject enough money into the Scottish economy to ensure that economy can grow (as will, no doubt, be the aim) then the Scottish Government will have to run a deficit because that is the only way that net injections of the essential government guaranteed money that keeps an economy revolving can take place.

Secondly, this understanding means that the Scottish Government does not need to think itself beholden to bond markets or their interest rate whims. When the relationship between government, money and tax is properly understood then what is clear is that a government need never borrow from anyone but its central bank (which effectively happens in the USA but which is illegal in the EU except for the quantitative easing ‘work around’ that achieves the same result). If the Scottish Government did then decide to issue bonds it would be because it wanted to, at an
interest rate it wants to set, and solely to provide people with opportunity to save in
the safest way possible.

Third, and most importantly for the discussion that follows, in this scenario tax
entirely ceases to be a mechanism that raises money to pay for government spending,
because that spending is paid for with loans made by the central bank to the
government. Tax is, instead, a means of reclaiming the money that the government
has spent into the economy as a result of that spending. And, if that is the case, then
the most important issue in tax system design (apart from making sure that inflation
is prevented) is to make sure that the taxes levied are consistent with government
policy in other areas of its work.

To be clear, this is not an argument against proper monitoring and accounting for
the velocity of money in the national economy. This should be rigorously accounted
for to protect the economy against dangerous levels of inflation. But it should be
done on the basis of accurate accountancy treatment which understands government
created money as national equity capital created with no cost and no repayment date,
akin to equity (or 'share') capital for a company. Accounted for as equity capital,
monetary creation can be created and monitored to ensure it meets the government’s
monetary policy goals. This, alongside a strategy to ensure the national economy
remains competitive with the rest of the world so as to prevent inflation driven
by exchange rate devaluation, should ensure an independent Scotland is uniquely
equipped for prudent and competent monetary policy and controlling inflation. See
the Appendix at the bottom of this report for a full explanation of this.

This understanding should underpin the future macroeconomic and tax policies of
an independent Scotland. With them in place the foundations of a secure and stable
state exist.

**The reasons to tax**

If the noted social and economic foundations for a Scottish tax system are accepted
then the full range of reasons for charging tax have to be explained. There are six
such reasons:

i. Reclaiming the money the government has spent into the economy. As already
noted, it may appear that tax revenue is being used to pay for government
services supplied but that is not true: government spending always comes
out of funds the government borrows from its central bank. Tax, in that case,
reclaims the money spent to prevent excessive inflation. The amount reclaimed
is that which is considered sufficient to leave the desired rate of inflation in the
economy.

ii. Ratifying the value of money. Because a government requires that tax be paid
using the currency that it creates (simply because that’s the currency it bills in)
that currency has for all practical purposes to be used in the economy for
which it is responsible, assuming that tax forms a significant part of people’s
total liabilities. The payment of tax does, therefore, give a currency its value in
exchange and as a result passes control of an economy to the government that
What this means is that an effective tax system has to recognise these six facts in its design.

**Theory into practice**

If these six reasons for tax are accepted then the practical principles that should guide the management of the Scottish tax system must recognise that tax is the single most effective instrument available to its government to shape the economic and social outcomes that it desires. Taking all the discussion to this point into account suggests that the following statements should form the basis for tax in Scotland:

i. The tax system should deliver the macro-economic goals of the Scottish Government.

ii. The tax system should reflect the social priorities of the Scottish people.

iii. The tax system should encourage the engagement of all in Scotland in the democratic process.

iv. The Scottish tax system should be effective in:
   - Reducing economic and social stress within Scotland and between Scotland and other states;
   - Encouraging truthful, tax compliant behaviour;
   - Minimising opportunities for tax abuse.

v. Additionally the Scottish tax system should be:
   - Integrated with other law, such as that regulating companies, partnerships and trusts to help deliver tax compliant behaviour and a level playing field for all Scottish businesses;
   - Adequately resourced to achieve these objectives.
The political foundations of Scottish taxation

Some practical assumptions

An independent Scotland will not, of course, emerge from nowhere. It will transition from being a part of the United Kingdom. This requires that a number of assumptions be made about this process.

The first is that there will be some time for the provisional government of an independent Scotland to put measures in place between the date when the decision to become independent is taken and the day when it actually happens. Such a transition will be essential if Scotland is to have effective government from the day after it leaves the UK.

Second, it is assumed that unless the Scottish Government decides otherwise the provisions of UK law tax will become Scottish tax law after independence. This was the case when Ireland left the UK in 1922 and was quite specifically provided for by Article 74 of the Irish Free States’ constitution.

Third, it is assumed that HM Revenue & Customs in Scotland will transition to become the Scottish tax authority and that the dual structure now in place will cease to exist. This will require that a shadow management structure for the new authority be put in place during the transition period. It is assumed in this paper that the new authority will be called Revenue Scotland.

Implicit in all three assumptions is the co-operation of those countries remaining in the UK.

The politics of tax

Precisely because tax is the most effective tool available to any government to implement its social and economic policies tax is, inevitably, at the heart of practical politics. You would not, however, know this from the way that tax has been managed in the UK. For example, HM Revenue & Customs is not directly accountable to ministers in the UK; there is no minister for taxation in the UK Government and there is no select committee on taxation in the House of Commons. All of these situations are very obviously inappropriate given the significance of tax in the political process. There may be historical reasons for this situation having arisen in the UK, but the legacy of the English civil wars of the seventeenth century need not impact Scotland in the twenty first century. As a result it will be necessary to create new structures to manage tax within the political landscape in which it will play an integral part within an independent Scotland. This requires five things.

The first is that there should be a minister responsible for taxation. They need not be the finance minister, but clearly they would need to co-ordinate very closely with them. That minister must have cabinet rank to make them fully responsible to parliament.
Second, there should be a ministry for tax that is independent of, but which should clearly liaise with, the Finance Ministry that would be responsible for managing the state’s spending. This ministry of tax would set tax policy to meet the objectives set by the Finance Minister (who would have overall responsibility for economic policy) and have oversight over the tax collection function. The division in tasks is important: it emphasises that tax is a support function that assists achievement of economic goals but is not a constraint upon them.

Third, to preserve the political independence of the tax collection function the ministry of tax would devolve such tasks to an administrative agency. For convenience I assume that this will be called Revenue Scotland. There is more discussion on its required structure later in this report.

Fourth, the tax minister, their department and Revenue Scotland would all have to be held to account. This will require that the Scottish Parliament have a tax select committee.

Fifth, to make sure that the committee in question has the resources to do its job properly there should be an Office for Tax Responsibility that should report directly to that committee. This Office for Tax Responsibility must in turn have four responsibilities. First it must act as the internal audit function of Revenue Scotland. Second it must audit the tax proposals the government makes to check their credibility. Third, it must review whether those claims are fulfilled in practice by checking the continued usefulness of all allowances and reliefs in the tax system on a regular basis and recommending changes if any have failed to achieve their stated purpose. Fourth, it must audit the tax gap, which is the difference between the amount of tax that should be paid each year and the amount actually collected. It must also monitor progress in closing this tax gap. There is no such function in the UK at present: Scotland must not replicate the mistake. The only way to ensure that the Scottish tax system is held to account is to provide the Scottish Parliament with the resources to ensure that this happens and an Office for Tax Responsibility is key to this.

Revenue Scotland

A Minister of Taxation must be responsible for the Scottish tax system, but an agency that is beyond political interference must be responsible for the administration of tax in the country. Revenue Scotland must fulfil that role, but must not be modelled on HM Revenue & Customs. The structure of HMRC has been rightly criticised for:

- Being too close to big business;
- Having too close a relationship with the biggest firms of tax lawyers and accountants;
- Being selectively hostile to smaller business interests;
- Being lenient on the wealthy whilst being inflexible in their approach to those on benefits.

There is evidence to support each of these suggestions. Parliamentary enquiries, particularly by the House of Commons Public Accounts Committee, have exposed cosy relationships and deal making with big business. As a matter of fact the
external directors of HMRC are only drawn from the ranks of big business and the largest firms of accountants. Revolving doors between HMRC and tax advisers have caused disquiet. There is no doubt that the rate of prosecution of big business and the wealthy is tiny (even when tax evasion is apparent, as has been the case when investigating those whose affairs have been disclosed by offshore leaks). It is a matter of record that HMRC have more staff investigating relatively insignificant benefit fraud than they do tax avoidance and evasion. The available evidence does then suggest an organisation captured by particular interest groups that results in bias towards those best off in society. Revenue Scotland must not replicate this mistake. A belief that a tax authority acts impartially on behalf of all in a society is now considered key to tax agency effectiveness and to high tax compliance rates (and so small tax gaps) amongst the population at large.

To ensure that this does not happen the governance structure of Revenue Scotland must be robust. This would suggest that it should have a Board made up of both Revenue Scotland personnel and people representing a wide range of stakeholder groups, and not just business interests. The groups to be represented might include:

- Large business;
- Smaller companies;
- The self-employed;
- Pensioners;
- Trade unions;
- The staff of Revenue Scotland;
- Charities;
- Civil society;
- Local authorities;
- The tax profession.

This change will not be enough in itself. There will also need to be strong evidence that Revenue Scotland is committed to delivering a fair tax system for the people of Scotland that puts peoples’ needs at the centre of its operations and thinking. The strongest indication of this will be the operation of a local tax office network that makes it easy for people to access tax office services. This is the exact opposite of the HMRC office closure programme that will leave just two tax offices in Scotland in the near future, with many people being hundreds of miles away from their nearest face-to-face help. If tax is at the heart of a community, and it should be, then this is a policy designed to break that link.

It will also require a very different approach by Revenue Scotland to the staff that it employs. They will need a strong career structure, with appropriate pay being attached to the tasks undertaken to make sure that suitable personnel are employed. That said the revolving door problem must be addressed: restrictions on the right of senior Revenue Scotland staff to work in the private sector would have to be applied for two years after they left its employment.

**Tax reporting**

One of the biggest problems in taxation is that very few people understand what the tax system does, how much tax is raised, from who it raises it and on what the government spends its resources on. This is despite the fact that this obviously
has influence upon the amount of tax raised, even if it is only because tax recoups the sum expended. To ensure that Scotland has a successful tax system this issue of incomprehension has to be addressed. This requires that the government of an independent Scotland publish information in a way that is readily accessible to, and as comprehensible as possible about, its accounts, both in total and by department, as well as about its tax system, again in total and by individual tax.

Looking at the accounting issues first of all, it is important that the UK Government’s approach to these issues is not followed. Whilst it is the case that the UK Government does publish accounts for its activities as a whole, and that each department does also do the same thing, the data in question is not publicised and is currently presented in a format that appears to have the objective of making the data as incomprehensible as possible, even to those with a reasonable level of understanding of accounting. Much of this information is also published far too late to be of any real use. Comprehensive, but relatively incomprehensible, accounts may be of use to a very limited audience of specialists but when it comes to its spending and to tax a government is accountable to a whole population and it has a duty to explain to them what it does in as clear a fashion as possible. This is a goal that appears utterly alien to the UK Government and to its Office for National Statistics at present and this must not be copied by an independent Scottish Government.

What this would require is that an independent Scottish Government publish its accounting data in interactive format so that a person could access information at whatever level they like. So, starting at a whole of government level it should be possible to see data on both income and spending information in a relatively simple format and then by simply clicking on totals to break that data down with increasing degrees of granularity until all reasonable enquiries can be answered. In addition, it is essential that information on outcomes against expectations be provided both in total and by department so that the ability of the government to deliver against its budgets can be checked by anyone who wants to do so. At present this is virtually impossible to achieve for the UK as a whole, and the data that is available is so jargon laden that few would understand it.

When it comes to tax there is also a very clear obligation to explain what each tax is meant to achieve, how it is meant to achieve it, how the tax works, and what it collects. This would, therefore, again impose a very clear obligation on Revenue Scotland to explain not just what taxes there are, but why they exist, what they are meant to achieve, how they are meant to achieve it and what success criteria will be used for the appraisal of whether or not they actually achieve that goal. This will be particularly important when it comes to appraising the effectiveness of allowances and reliefs, many of which are abused by those seeking to artificially reduce their tax liabilities. By implication this will mean that the pro-active monitoring of the performance of taxes, not just at broad level, but in detail, will be a necessary part of the workload of Revenue Scotland and that this should be monitored by the Scottish Office for Tax Responsibility. No such monitoring takes place in the UK at present. When it is estimated that UK wide tax reliefs cost as much as £400 billion a year in revenue foregone this is not a practice that Scotland can afford to replicate. Comparisons between budgets and forecasts, including those made when an allowance or relief is introduced, will be an essential part of this process.
The final, and essential component in Scottish tax reporting will relate to the tax gap. This can be described as the difference between the amount of tax that should be paid each year and the amount actually collected. In itself this is a key measure of the efficiency of the Scottish tax system, but if the reasons for this tax gap were also properly understood and changes were made to address the issues arising, including those intended to change behaviour, then the tax gap is not just a measure, but a tool to be used to improve economic management within Scotland and to better deliver the social objectives of the Scottish Government. This is why it is so important that the tax gap is measured by Revenue Scotland and that its assessment be checked and reported upon by the Scottish Office for Tax Responsibility.

Securing the data needed to underpin Scottish taxation

Tax related data

Securing the data required to deliver a robust tax system is a six-stage process:

1. **The tax base has to be robustly defined.** This is the first essential step in creating progressive taxation and in promoting the better use of resources within society. The tax base is the income, wealth, transaction or other resource (such as a property) that is to be taxed. A robust definition makes it clear precisely what is charged in a way that leaves little or no room for challenge. This might require a radical change in approach to the way in which tax legislation in Scotland is written. At present UK tax law is written in a way that means that unless a source of tax is very precisely defined to be within the tax base it is not considered to be so. This has provided decades of opportunity for tax abusers seeking to avoid law written in this way. Scotland will need to write its tax law purposively, making it clear that whole classes of transaction and assets are within the law unless specifically excluded from being so. The opportunities for tax abuse should be reduced as a result.

2. **The tax base has to be found.** If the taxpayer, income, wealth, transaction or property that is to be taxed cannot be located then it is, of course, impossible to tax it. This issue is more broadly based and complex than this comment might suggest. Finding the tax base requires systems that are capable of determining:
   a. - Which people are in Scotland;
   b. - The companies that are active in Scotland, including those doing so that are incorporated in other countries;
   c. - Who is trading;
   d. - Who might be importing and exporting, as well as what they are bringing into and out of the country;
   e. - Which people are in employment;
   f. - Who owns assets such as land and buildings, shares in companies, bank accounts and other valuable property such as patents and copyrights as well as moveable assets such as vehicles, planes and yachts if they are to be taxed. Comprehensive record keeping systems are required as a result, with verification of ownership being an essential component in all such systems. Many of these systems will have use for purposes beyond the tax system. The UK does not have all these systems at present and Scotland will need to develop those suitable to its needs.
3. **The tax base has to be counted.** Unless the tax base can be quantified it cannot be taxed. This requires that accounting and valuation systems appropriate to Scotland’s needs are in existence. At present UK accounting standards are not designed to produce information that is necessarily suitable for tax purposes. This is an issue that Scotland may wish to address, requiring the production of accounts within the country that supply the data that its tax system might need if the right amount of tax is to be paid by the right person, at the right rate and at the right time.

4. **Assess the tax base at the right rates of tax.** In many cases this is a straightforward process but there are occasions when the relationships between related taxpayers, in particular, needs to be properly appraised to ensure that the appropriate tax rate is used.

5. **Allocate the resulting revenues efficiently and to best social effect.** This requires that a government has a robust and accountable budgeting system.

6. **Report on the outcomes of taxing:** this is an issue discussed in the previous section of this report.

The issues arising from these observations are wide-ranging and complex, particularly because they will require considerable input of effort to ensure that appropriate accounting and other systems are in place, many of which will not be inherited from the UK but which will be, if anything, of greater significance to an independent Scotland than to the UK as it is at present because it will be a smaller state with relatively open borders that will have to make sure that robust systems are in place to ensure that those who are liable to tax within it can be properly identified.

**National income data**

If a tax system is to be properly managed high quality national income accounting data is required. This, in particular, means that data is needed on the total levels of the following within the economy:

1. Consumption by households;
2. Investment by business;
3. Government spending;
4. Imports and exports;
5. Wages;
6. Rents;
7. Profits,
8. Production;
9. Movement in inventory levels.

These are the basis on which gross domestic product (GDP) can be estimated. A reliable estimate of GDP is essential if the total tax base is in turn to be properly estimated, which is also a pre-requisite of tax-gap calculation. Scotland does not have suitable systems to prepare the necessary data at present. The GERS statement – the Government Expenditure and Revenue Scotland statement – which has been used by the Scottish Government since the 1990s – has, for example, twenty-six income sources in its total recorded revenue but twenty-five of these are estimated,
many from whole of UK data extrapolated on bases of uncertain relevance for use in Scotland. If Scotland is to have a reliable and accountable tax system it is essential that it has its own system of national accounting and official statistics that is suitable for the purposes of Scottish decision making, which GERS has never been.

The taxes that will be needed

Introduction to this section

The Scottish tax system will need to fulfil the six roles for taxation already outlined in this paper. To achieve that goal it is likely that the Scottish tax system will have to incorporate a wide range of taxes. It is also clear as a result that many will look like the taxes already in operation in Scotland because most modern tax systems have developed a certain uniformity about their structure, commonly including:

- An income tax charged on a wide variety of sources including:
  - Pay from employment
  - Self-employed income
  - Pensions
  - Benefits
  - Investment income including rents, interest, dividends, income from trusts and copyrights
- A tax on company profits
- A capital gains tax
- A wealth tax
- National insurance
- Value added tax
- Transactions taxes e.g. stamp duty
- Specific excise duties e.g. on oil, alcohol, vehicles and tobacco
- Customs duties on imports
- Land based taxes, often linked to local taxation systems
- Taxes on specific issues e.g. land fill, car road fund licences, airport taxes, etc.

It is to be expected that Scotland will have all these taxes in varying guises. To the extent that the resulting taxes will be familiar from current UK experience comment will not be made here. What is of importance is the ways in which Scotland might want to innovate the tax system to create an integrated tax system that very specifically meets its needs. It is on this issue that this section concentrates after noting those ways in which the UK tax system falls short of meeting the goals for a twenty first century tax system previously noted. As a result new taxes are recommended.

Failings of the existing UK tax system

Some of the weaknesses that need to be addressed in the existing tax system are noted in this section. The list is not comprehensive and cannot be in the space available.

Income tax
- Very generous allowances for many of the savings and investments that only the wealthy can take advantage of
- Subject to far too many allowances and reliefs especially with regard to savings and dividends that are making tax return preparation extremely complex
- Generous allowances for rental income
- Low top tax rate
- High starting threshold leaves many with no relationship with the tax system
- High rates of tax evasion amongst the self employed in particular
- The domicile rule still allows discriminatory taxation without economic justification
- The dividend tax discriminates against one sort of investment income and encourages renting
- Low levels of staffing dedicated to making sure that the system is properly monitored

Corporation tax
- Very low tax rate. 19% rate is well below international norms
- Low tax rate encourages abuse of the income tax system, especially by the wealthy who do not need to live on the income that they earn each year
- Exceptionally poor policing of the system: maybe 600,000 companies a year are excepted from submitting tax returns with almost no evidence supplied to support their claim for being exempted and a further 400,000 or so companies a year fail to submit corporation tax returns despite being asked to do so
- Low level of monitoring of the system: only 1.25 million companies paid tax in 2014-15 tax year when there were 3 million companies in existence
- It is legally very hard to make the directors of a limited company responsible for the tax liabilities of a company that they own when they have been responsible for its tax abuse
- The tax rate is not progressive

Capital gains tax
- Rates much lower than income tax reduce yield and greatly encourage tax avoidance activity
- The annual allowance for the tax is very generous and essentially provides a second annual tax free allowance to those who are well off
- The tax rate is not progressive
- There are exemptions and allowances, e.g. entrepreneur’s relief, that appear to have little economic justification but are very costly despite being enjoyed by relatively few people a year
- The tax exempts private housing from charge and has, as a result, helped distort the housing market
- The tax is especially generous to couples in legally recognised relationships with the reliefs provided to them being open to abuse, including to reduce and even eliminate tax charges
- Application of the domicile rule allows for discriminatory taxation
- The tax is poorly enforced. There is, for example, evidence of poor enforcement in the buy-to-let market

Inheritance tax
- Poorly designed: in particular very high allowances and non-progressive tax rates when charge arises
- Very easy to avoid: arrangements for lifetime gifting are open to wide abuse and are very hard to monitor
- Discriminates in favour of those already wealthy. For example, those already well off may make higher tax exempt ‘gifts out of income’ than those with lower earnings
- Some allowances are very hard to justify. Allowances for agricultural property and AIM stock exchange registered shares have been subject to widespread criticism and are reliefs easily open to abuse
- Trust arrangements remain open to use for the very wealthy
- Arrangements for non-domiciled people have been improved to reduce discriminatory aspects but still exist
- Poor enforcement arises from poor information systems and a lack of resources
- Likely to be regressive on those with most wealth with rates being highest on the middle range of estates charged because higher value estates tend to enjoy more allowances and reliefs

**National insurance**
- A tax designed for another era when most had only one job, unemployment was low, multiple employments rare, self employment uncommon and those with investment income few and far between that is now showing considerable signs of weakness
- Inequitable to those in multiple employments, sometimes not giving rise to credits being paid, and sometimes resulting in charges hard to monitor and assess as to accuracy
- Subject to different rules on what is self employment and what are allowable expenses on occasion to income tax, result in confusion
- Rate differential for the self employed becoming harder to justify in some cases
- Open to widespread confusion as to its purpose which the government rarely does anything to alleviate
- The employer’s contribution is little understood by those for whom it is paid
- Open to widespread abuse by those in self-employment (whether real or disguised) who form companies to generate their income and then pay themselves minimal salaries and dividends over that sum to avoid both employee’s and employer’s national insurance charges. This is a scheme partaken in by employers and the self-employed alike. Hundreds of thousands of companies are likely to have been used for this purpose. The true scale of the revenue loss is unknown but is considerable. The so-called dividend tax has not stopped the practice
- Is not charged on investment income meaning that the overall tax rate on those with investment income tends to be much lower than that paid by those who sell their labour for a living
- Regressive because the tax rate falls when the employer’s basic contribution cap is reached

**VAT**
- Is regressive because it only applies to consumption and those on the lowest levels of income have the highest rates of consumption in proportion to income
- Is regressive because many of the tax example items relate to items bought by those on highest incomes e.g. private education, private healthcare and
Improvements required to create an effective Scottish tax system

These facts, in combination, suggests that there is room for considerable scope for reform to the UK tax system when adapted for use in Scotland:

Income tax
- The personal allowance has to be reduced; the more people are engaged with the income tax system the more they engage with the political process. There is a danger that those who do not pay income tax ‘do not count’ and it is a risk that must not be taken;
- The number of tax bands in use in the income tax system must increase. It makes no sense not to use a low, ten per cent starting band, and a thirty per cent band to ease the transition to higher tax rates;
- There is no evidence that a fifty per cent income tax rate is a disincentive to work or to living in a country: the rate should be in use;
- There should be a nominated ‘base rate’ of income tax. A twenty per cent rate is likely to suit this purpose. All tax allowances and reliefs should be given at this rate irrespective of a person’s level of income. This would mean that a person with no income might have an allowance of £1,600 available to them if the personal allowance was £8,000 per annum and could claim this sum.
- Those on higher tax rates would always get a personal allowance but all tax allowances available to them for any reason would only be given at the twenty per cent tax rate, reducing the value of many of the tax reliefs now largely claimed by those with higher earnings. This allowance could be factored into student incomes. If extended to children it could become a central part of the benefits system and restore child allowance to all children, who should enjoy that equality within the system. It could represent a first step towards a basic income. The cost of the allowance given would be offset by the restriction off allowances and reliefs at higher rate. The goal of this reform would be to:
  - create tax simplification
  - increase representation in the tax system
  - encourage registration with that system to increase tax compliance rates
  - reduce inequality
  - reduce the economic distortions that many existing incentives and allowances create within the tax system.
- The estimated cost of the UK personal allowance as currently structured is £97.4 billion in 2016-17 tax year. If all 65 million people in the UK get an allowance with a cash value of at last £1,600 the cost of the relief would be £104 billion. The difference and the cost of a lower tax band for starting incomes could be recovered from the removal of higher rate tax reliefs.
- Investment income should be subject to a surcharged income tax rate when it exceeds £3,000 per annum. The surcharge should start at fifteen per cent. A higher rate should be considered in the event of there being significant investment income. An age allowance should be made for pensioners but this should not apply to all income levels. This charge is to compensate for the absence of national insurance on this source of income.
- All tax incentives for savings should be reconsidered, including those for ISAs. Modern economies are suffering a glut of savings. There is no reason to incentivise what is already commonplace, if only for a minority in society. If saving is to be encouraged the reliefs available should be restricted in total amount per annum.
- Enhanced resources should be expended in identifying the income of those who are self-employed and who do not disclose the fact, who are likely to be major contributors to the tax gap. This should include the provision of data by banks on those persons whose pattern of bank deposits implies a regular source of non-salary related payment.
- To discourage the cash economy all notes of more than £10 in value should be withdrawn from circulation and no payment of more than £200 in cash should be considered legally permissible.

Corporation tax
- All companies should, without exception, be required to submit a corporation tax return each year.
- No company should be incorporated without the proof of identity of all shareholders owning more than ten percent of the capital and of all directors (one of whom must be domestically resident) being made available to tax authorities. This data should be updated annually. If it is not the company should lose its limited liability and this fact should be recorded at Companies House and all its directors and all shareholders owning more than ten per cent of its shares should become jointly personally liable for its debts, including on tax.
- The directors and all shareholders owning more than ten per cent of the shares in a company should also become personally liable for its tax liabilities if at any time it fails to file a document required by Companies House or a tax authority within ninety days of that declaration being due. The hiding of tax liabilities behind corporate negligence has to cease.
- Banks operating a bank account on behalf of any company should be required to report annually to both Companies House and to Revenue Scotland who they think the directors and persons owning more than ten per cent of the shareholdings in the company are and this data should be recorded on public record as a check on the data that the company itself supplies.
- The rate of corporation tax should be increased. That for smaller companies should be at least five per cent more than the basic rate of income tax to ensure payment is made for the benefit of limited liability that the owners of a limited company enjoy.
- The rate of corporation tax for large companies should be at least ten per cent higher than the basic rate of income tax to ensure that the corporation tax system is suitably progressive. As compensation one hundred per cent tax relief should be available on the cost of all sums invested in Scottish business (as opposed to renting and financial services) activity. This would significantly increase the incentive for Scottish business to reinvest in the Scottish economy.
- All Scottish dividend payments should be subject to a tax withholding equivalent to the basic rate of tax to ensure that tax is paid on all profits arising in Scotland that are used to fund personal incomes.
- The country-by-country reporting of Scottish companies and the groups in which they bare members as submitted for tax purposes should be published on public record as a condition of Scottish accounting law.
- There will be a strong commitment to corporation tax: it is a back stop against income tax abuse; provides stability to business; delivers incentives to invest and ensures business pays its way to the society that hosts it. As such it forms part of a progressive tax system.

Capital gains tax
- Capital gains should be taxed as if they are income and be added to the top part of a person's income. There is no economic logic to treating income from capital gains differently to that from other sources. An allowance for inflation when calculating gains would, however, be appropriate in this case to allow for the varying value of money over time.
- The value of the annual capital gains tax allowance should be reduced considerably to a sum equivalent to no more than £2,000 and this should be solely to save administration costs.
- The gain realised by one partner to a marriage or civil partnership on an asset transferred to them by the other party in that relationship should be taxed as if
made by the donor party if realised within three years of the gift being made to prevent abuse of this relief.
- Capital gains tax entrepreneur’s and reinvestment reliefs should be abolished as they only serve to increase inequality.
- Capital gains tax should be applied to the accumulated capital gain inherent in the sum realised on death on disposal of a former principal private residence taking into account all such properties owned during life. If the property has been jointly owned within a marriage or civil partnership the gain should be charged on the second death. To prevent abuse, all disposals of principal private residences not resulting in the entire sum being reinvested in a replacement property within five years of disposal should also be subject to a capital gains charge, with the charge being due in the year of sale but subject to repayment when reinvestment occurs. Principle private residences would, as a result of this charge otherwise be exempt from wealth taxation. Provisions to cover arrangements on divorce will be required.

Wealth taxation
- Inheritance tax should be abolished: it is open to many abuses.
- Capital gains tax should be charged on death.
- A lifetime gift receipts tax should be created. Any person should be allowed to a fixed capital sum during their lifetime. No relief for quick succession (i.e. re-gifting to another person) should be permitted. A recipient receiving an inheritance that brought their cumulative receipts of capital above the designated sum should have that excess added to their income for taxation purposes in the year of receipt. At the time of introduction all receipts of capital in the seven prior years should be considered to be a person’s lifetime receipts.
- An annual wealth tax should be charged at a low rate on all personal wealth exceeding £2 million, excluding a share in a principal private residence but including pension funds (which are only a tax favoured form of savings account).
- Higher rates of wealth tax should be applied to the property of all trusts without identifiable settlors and with discretionary beneficiaries.

National insurance
- National insurance thresholds should be above and not below income tax thresholds to:
  - compensate for reduced income tax allowances
  - encourage employment
  - Reduce employer administration costs
  - Reduce the risks of double charging from multiple employments
- The pension credit now earned by making a national insurance contribution should instead arise from having taxable employment income sufficient to give rise to an income tax liability.
- The upper threshold for national insurance contributions should be abolished but that should be matched by the introduction of a thirty per cent income tax rate to compensate a majority of those impacted.
- The eventual replacement of national insurance with a universal carbon usage tax (see below) should be planned.

VAT
- The VAT exemption of financial services, health care provision for profit and education for profit should be abolished as these all subsidise the consumption
of those best off in society.
- VAT relief to encourage the renovation of existing properties should be introduced.
- VAT zero rating on the installation of energy efficiency products should be introduced.
- Charities should be allowed to reclaim VAT charged to them in the conduct of their charitable activities.
- The VAT return of those businesses required to register should be adapted to be the basis of digital recording for tax purposes and no further impositions of new administrative systems should be created for smaller businesses.

A financial transaction tax (FTT)
- The finance sector has been under-taxed. It has not been subject to VAT.
- It does as a result have a competitive advantage over other sectors of the economy.
- Even if (as noted above) VAT was added to its charges the finance sector would continue to represent a threat to the stability of the economy, as was evidenced in 2008. As a result a tax is required to modify its tendency to reckless behaviour and to compensate society for the costs that it imposes. A financial transaction tax does that.
- The UK already has a successful FTT. This is stamp duty. It is charged at surprisingly high rates and does not appear to be an impediment to share trading. This success should now be broadened.
- The stamp duty should now be extended to banks’ own trading accounts: it makes no sense that they can trade tax free when others cannot and this relief can be abused.
- The stamp duty should be extended to all share related financial derivatives: systems to track these now exist.
- The FTT should also be charged on other forms of financial trading, including on foreign exchange trading, where the vast majority of trades are speculative.
- The aim is to reduce the volume of trading in these markets that are a potential source of financial instability. The rates charged will be tiny; fractions of a percent will be appropriate, but the impact will be to increase the cost of trading and so reduce speculative risk.
- The FTT should include a facility to rapidly increase rates in the event of large swings in asset prices or in the case of currency volatility. At such times there tends to be panic that can remove all market liquidity as people try to sell, whether it is rational to do so or not. A rate escalator can reduce volatility and calm markets in this situation.
- An FTT reduces inequality, levels the tax playing field, addresses externalities and can reduce market shocks. It may raise useful revenue, but that is largely a secondary factor in its design.

A Carbon Usage Tax
- The UK’s indirect taxes (VAT and excise duties) plus its system of specific tax charges (BBC licence fee, road fund licences, etc.) are regressive in their impact. The UK needs a progressive indirect tax to rebalance the tax system in addition to the changes already noted under direct taxation. The Carbon Usage Tax (CUT) is intended to achieve that goal and to eventually replace national insurance charges.
- The CUT will be charged on the flow of funds through a person’s bank account. The charge will be levied by the bank and will be progressive. For most people the rate will be set at zero per cent and it is expected that this will remain true even when the CUT replaces national insurance. The rate will, however, be progressive and be applied to all flows into and out of accounts excluding those that are transfers between accounts a person has (e.g. their loan, savings, current and mortgage accounts, including in different banks). Initially charged monthly the CUT would be adjusted to an annual charge at each year end.
- Resident people who do not appear to have a bank account for CUT purposes or who cannot explain their low rate of bank account usage will be assessed to the tax based on their income.
- The tax is intended to tax higher levels of consumption, as indicated by higher levels of spending, at higher rates. It is intended to reduce that consumption as a result and act as a green tax as well as an eventual replacement for national insurance that discourages job creation, when what should be discouraged is excessive use of the world’s resources.

**Beating tax abuse**

In addition to the changes required to the Scottish tax system noted in this section, and previous sections, it is vital that Scotland builds a robust system to beat tax abuse within its tax system. The following recommendations are made:

**Scottish tax law should be principles based**
- Scottish tax law should say what its intention is as well as specifying the specific ways in which it is to achieve that goal: this way ambiguity in the meaning of tax law should be reduced.
- Tax abuse should then be defined as seeking to circumvent the intention as well as the letter of the law.
- In this way Scottish tax law will build on the Roman Law concept of the abuse of law. This only so far applies in the UK with regard to VAT - an essentially European tax, where it has been very effective.
- The result is that Scottish tax law should always be interpreted purposefully i.e. a taxpayer will only ever be compliant with it if they have sought to comply with the intention as well as the letter of the law. The burden of proof should be on the taxpayer.
- To back all this up Scotland must have a tough General Anti-Avoidance Principle built into its tax code.

**International tax abuse**
- Scotland should seek to adopt double tax treaties based on the United Nations principles and not those of the OECD. The United Nations principles reflect the rights of the state where income arises to tax a source of income in the first instance. The place where the owner of the income is resident, if that is not the same as the place where it is earned, then only has a secondary right to tax it, having given credit for the tax paid in the place where it is earned. This is now an essential protection against the shifting of income to tax havens.
- Scotland must tax its resident companies and their subsidiaries on a resident basis of the type used by the UK before 2009 but with stronger controlled foreign company rules.
- Scotland should seek a five year moratorium to renegotiate the tax treaties it would inherit from the UK on this basis.
- Scotland should commit to full automatic information exchange for tax purposes.
- Scotland should commit to full public country-by-country reporting for all companies based in its jurisdiction.
- Scotland must commit to all Scottish companies filling their full accounts on public record and its Register of Companies must provide full details of the beneficial ownership of all Scottish companies.

**Beating domestic tax abuse**
- Any bank trading in Scotland must be required to provide full details to the Scottish authorities of any account that they maintain anywhere for any Scottish resident person or company on an annual basis, including the total sum deposited in the account each year. Nothing will be more effective in tracking down tax abuse than this.

**Investing in tax**
- Scotland must invest in its tax system: this requires that it adequately resources its tax administration. It also requires that:
  - *The principles and details of Scottish tax is taught in schools.*
  - *Appropriate university education in tax is available.*
  - *Research into tax is sponsored.*
  - *A career progression in Scottish tax is available to those who want it.*
  - *There is maximum transparency on the workings of the Scottish tax system to ensure that it is accepted in Scottish society, which is the goal of all good tax systems and the basis of which maximum tax compliance is achieved.*

**Appendix: The accountancy treatment of government money creation as equity capital and controlling exchange-rate driven inflation**

As this report argues, government spending creates new money for circulation in the economy, at literally no cost. What it also argues is that an independent Scotland with its own currency should use this ability to generate economic activity to optimise capacity in the Scottish economy, most obviously through maximising employment. At that point tax has to be used to cancel new money created by government spending.

Based on this understanding, we should be clear that an independent Scotland will need to create more money by spending more than it may claim back in tax, at least for a period. This spending will either create new Scottish assets (like infrastructure) or will, when used to pay for public services, look like what is conventionally called a deficit.
In accountancy terms, the credit side of the government spending transaction is usually recognised as national debt. Since much of that credit balance is at present sold off as debt to insurance companies, pension funds and savers looking for a safe place for their funds, that isn’t wholly inappropriate as a way of describing the credit balance that is managed in this way. But what is important to note is that when this happens the country’s debt then becomes private wealth in the new owners’ hands. There is no mistake in saying that. Government debt always represents private wealth: double entry accounting demands that this is true.

There are many forms of private wealth, and another type often favoured by those same institutions that buy the national debt is ‘equity capital’. In companies this is called share capital, and the same companies that issue this equity, or share, capital often also issue debt. The two can comfortably co-exist alongside each other and both are credits on the balance sheet of a company and of a country, if only a country were to recognise that it too might have equity capital.

An independent Scotland should have equity capital in its accountancy treatment.

Unlike debt, equity capital is usually issued without a repayment date, indicates ownership of a stake in the concern, and maybe a vote, and is considered to be the foundation on which the company is built. Indeed, it’s usually said that a company is run for its shareholders, who are the people who own its equity capital.

National equity capital would reflect the fact that countries do have people they are run for, and that this is reflected in the accountancy treatment of a government. There is no reason why this should be the case for companies and not for countries.

Now suppose that the money a country can create costlessly if it wants to do so was not treated as debt reduction (as happened in the case of the UK’s QE programme) but was instead treated as being the equity capital of a country held in trust for all time for the benefit of the people of that country.

A special body, or court, elected by the people of Scotland, or alternatively drawn from a second parliamentary chamber, could become trustees for this capital. The capital in question would not need to be repaid as it was created out of nothing and cost nothing to create. But it would, nonetheless, be the core funding that would keep the Scottish money supply under control, increasing over time if economic expansion demanded it, and potentially reduced if the risk of inflation demanded that as well.

To be clear: this money would not be debt. It would be Scottish equity capital: the money created by the nation for the people of Scotland to be held on their behalf by trustees, but with the Scottish Parliament responsible to the electorate for its careful management in the interests of all. This is entirely technically possible, but would need to be created outside of the EU (as Scotland would be bound to be for a period) as it would be forbidden under current Maastricht rules.

This accountancy treatment would allow for accurate assessment and monitoring of the velocity of money in the national economy.
It would not however eliminate one risk that should be mentioned, and that is that some inflation is transmitted into a national economy through the exchange rate. If the currency becomes devalued for any reason then imports become more expensive and domestic inflation can be created. Admittedly, exports are encouraged and that can help balance an economy over time, but there is no doubt that shifting exchange rates (and having its own currency would expose Scotland to such moving rates) could create this inflation risk. What is to be done about that?

There are three answers. The first is that if there has been no general shift in the productivity of labour in Scotland compared to that in the rest of the world and nor if there is a shift in commodity prices then any exchange rate shift in that case indicates speculation and will probably be short term. Long term exchange rate moves are usually linked either to commodity prices (where Scotland is, overall, well protected because of its energy resources) or labour productivity.

Alternatively, if weak productivity suggests that Scotland is not earning its keep compared to the rest of the world it is a mistake for a government to pretend otherwise by trying to increase financial flows into the national economy through dubious speculative means, including incentivising international finance through creating optimal circumstances for tax abuse and spending reserves to buck the market. Both, however, create more problems than they solve.

The government would be better advised to use its domestic resources to create the necessary investment in Scotland to rebuild its export capacity and so encourage the exchange rate up again. This is where the economic logic of this paper really kicks in, and where the idea of national equity capital – money created to fund national investment – really makes sense. The aim in this case is not to speculate a way out of the problem, but to solve it by government investment to improve its trade balance and a tight tax policy to prevent domestically created inflation. This is the real way to beat the risk of exchange-rate driven devaluation and inflation.
References

1  http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q102.pdf


