A FAIRER WAY

REPORT BY THE LOCAL GOVERNMENT **FINANCE REVIEW** COMMITTEE

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Local Government Finance Review Committee, Edinburgh 2006

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FOREWORD

The Committee appointed to consider local government finance and associated matters have pleasure in submitting their Report to the Scottish Ministers.

We must express our thanks to the many people and organisations who responded to our questionnaire, who took part in our surveys, who submitted written or oral evidence and who otherwise assisted the Committee in our deliberations.

The Committee wish to place formally on the record our appreciation for the invaluable advice and enormous contributions made by Kenneth McKay, our Specialist Adviser, and David Milne, our Secretary.

As an independent Committee, the conclusions and recommendations in this Report are our own.

SIR PETER BURT
Chairman

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SECTION 1: EXECUTIVE SUMMARY

1. Every household benefits from the services provided by local authorities and almost all households pay council tax.

2. The Committee resolved to find a way to ensure that, as far as possible, local tax bills are fair and that the local services on which we all depend have a reliable source of funds. The stakes are high. The average council tax bill payable in Scotland in 2006-07 is £958.[1] However, council tax provides only 20% of local council revenue expenditure, with 80% coming from the Scottish Executive.

3. While the Committee's remit emphasised local taxation, we quickly concluded that a proper review could consider neither local taxation nor local government finance in isolation. In particular, we cannot separate local government finance from the services it funds or from the broader role of local government. Nor can we divorce local taxes from the basket of UK taxation. The consequences of these conclusions follow.

4. First, there is the fundamental question about what the relationship between central and local government should be. There is long-standing and unresolved debate about their respective roles. The Committee's view is that it is essential that the Scottish Parliament, the Scottish Executive and local authorities grasp the nettle and resolve what appears to be a corrosive argument about their relationship. We hope that the recent debate initiated by *Transforming Public Services*[2] can serve as a catalyst towards this.

5. Next, there is the relationship between finance and the roles and responsibilities of central and local government. The received wisdom, dating back at least to the Layfield Report of 1976, is that local tax-setting and tax-raising powers are essential to ensure local accountability. Some representations to the Committee argued that local tax-setting powers distinguish local government from local administration. The Committee looked long and hard for objective empirical evidence to support this theoretical argument. No such evidence was either produced by any respondent or found by the Committee in our other deliberations. On the contrary, results of public survey work commissioned for our review found that people were much more likely to be influenced by questions over local services and issues and over the use of public money than on the level of council tax.

6. The Scottish Parliament is accountable to the people of Scotland because of the extent of its responsibilities and scope of its discretionary powers, despite having only limited tax-setting powers. We conclude that the extent of discretion over how local authorities actually spend their money is a more appropriate test of local accountability than the existence of tax-setting powers.

7. In that context we conclude that the balance of funding between Scottish Executive support and local tax income is of itself of little importance. To many in local government, moving the balance of funding towards 50:50 would protect local authorities from the effects of perceived under-funding and signal parity of esteem between central and local government. In our view, these concerns are tangential to the real issues, namely clarifying the relationship between the Scottish Parliament, Scottish Executive and local government and ensuring the right level of funding for local services.

1 Scottish Executive, *Council Tax Datasets*

2 Scottish Executive, *Transforming Public Services* (2006)

8. We also conclude that consideration of local taxation cannot reasonably be separated from the broader context of UK taxes. The UK basket of taxes contains many components, each of which targets specific elements of how people and businesses obtain and use income and wealth. Decisions about the contribution to be raised by each type of tax often require delicate adjustments to be made to optimise tax yield and to minimise unintended consequences in terms of effects on the economy and people's behaviour.

9. A number of consequences follow. Most obviously, a local tax should not distort the overall balance struck by the basket of taxes, in terms of yield and other effects. Furthermore, this balance should be achieved in as efficient a way as is practicable. In theory, a local tax system which replicated and mirrored the national tax system would not upset this balance. However, it would be extremely complex, inefficient and expensive.

10. In this context, the Committee focused its consideration on income and local property taxes. The Committee also considered taxes on transactions (e.g. sales tax, fuel tax) and on individuals (poll taxes). However, these latter two did not satisfy the criteria we use to assess the suitability of forms of local taxation.

11. Income taxes are apparently regarded by taxpayers as being fairer than alternative forms of taxation because taxes on income are related to ability to pay. However, income tax already makes a substantial contribution to UK tax revenues.

12. The Committee concluded there were objections both in principle and in practice to a local income tax. These include the following:

- The tax base should be as broad as possible. Around one-third of UK tax receipts already come from UK income tax.
- Wealth, as well as income, should be taxed.
- Additional income tax is a disincentive to work, which is economically undesirable.
- Yield would be more volatile than under a property tax; and
- A local income tax would be "fair" only if it was levied on all income but it would be extremely complex and expensive to do so. A tax that applied only to earned income would arguably not be "fair".

13. The UK has no form of annual taxation other than council tax on property or other assets. In a Scottish context, we are satisfied that property is a reasonable proxy for wealth.

14. Property taxes can be seen to be "fair" and progressive, because there is a correlation between property values and ability to pay. Evidence suggests that, where this correlation does not apply, it is more likely to arise from households on higher incomes living in lower-priced homes than vice versa.

15. Property taxes are better suited for use as a local tax than income tax. They are difficult to avoid and suitable for collection locally. They are certain: while they lack buoyancy, they are not susceptible to sudden reductions. This is a major advantage for local authorities whose costs, year-on-year, are fixed in the short term.

16. We considered council tax in its present form and possible reforms to improve its progressivity. We examined and modelled possible changes to the number of bands and the multiplier between the lowest and highest bands. The results failed to meet our criteria. Consequently, we were unable to recommend either continuation or reform of council tax.

17. Having considered and rejected all the options put to us, we concluded that a radical alternative is required. We recommend a new progressive Local Property Tax (LPT) be introduced, based on the capital value of individual properties and payable by households occupying properties (whether as owner-occupiers or as tenants) and by owners of second homes and unoccupied properties. LPT satisfies our criteria.

18. Around two-thirds of households in Scotland would be either better off or no worse off with LPT than under council tax. The gainers would primarily include households in lower income deciles, and in properties currently in council tax bands A to C.

19. Revaluation of domestic properties is a prerequisite to the introduction of LPT. We recommend routine regular revaluations, which are backed by statute and which would be yield-neutral.

20. We also conclude it is not appropriate for decisions about the shape of a local tax to focus primarily upon the interests of the relatively small number of "asset rich, income poor" households at the expense of most households in Scotland. Nevertheless, we have considered assistance for this group and describe a possible optional deferment scheme which could be valuable to such households.

21. We considered possible changes to non-domestic taxation. In the light of evidence received, we recommend the retention of non-domestic rates and the status quo.

22. We also considered a number of associated issues. Of our recommendations, the most significant is that principles of local accountability and good government demand the removal of the statutory requirement upon local authorities to collect water and sewerage charges alongside council tax bills. We also recognise the role that specific taxes or charges may have in supporting investment activities or encouraging positive behaviour. However, in the context of core funding, such taxes could play only a minor role.

SECTION 2: OUR REVIEW – ITS REMIT AND ITS CONDUCT

ESTABLISHMENT & REMIT

1. Our review stems from the Partnership Agreement between the Scottish Labour Party and Scottish Liberal Democrats, which set out the principles on which the coalition government of the Scottish Executive between 2003 and 2007 would operate. The agreement states that:

> "following consultation with COSLA, we will establish an independent review into local government finance".[3]

2. The then Minister for Finance and Public Services, Andy Kerr MSP, announced the establishment of the Committee and details of its remit in a statement to the Scottish Parliament in June 2004,[4] with details of membership of the Committee being confirmed shortly afterwards.[5]

THE SCOPE OF THE REVIEW

3. The remit we have been given, which is outlined below, is broad. This is reasonable since local government finance touches on many issues, as the list of "associated issues" in the remit demonstrates.

4. One question we had to address is how closely we should consider these associated issues as part of our work. We have interpreted the remit in a way that restricts our consideration of these associated issues to the extent that they inter-relate with the question of local taxation. This is in our view the only sensible interpretation of our remit. Other issues listed, such as the structure of the broader local government finance system, the mechanism for distributing grant among local authorities and the regime for financing Scottish Water, are substantial and complex matters in their own right.

5. It became clear at a very early stage of our discussions that another major theme is the relationship between the role and functions of local government and the local taxation by which it is partially funded. A clear definition about how local services should be shaped and delivered is critical in reaching decisions about local government finance. We have concluded that local government is financed to deliver effective local services. The significance of the debate about local taxation must be seen in that context. Whilst we have not entered into the debate about how local services should be delivered, we recognise that our recommendations about local taxation must be able to cope with a range of possible scenarios regarding the future delivery of local services. We discuss this issue more closely in sections 5 and 6 later in this report.

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3 Scottish Executive, *A Partnership for a Better Scotland: Partnership Agreement* (2003)

4 Scottish Parliament, *Official Report*, 16 June 2004

5 Scottish Parliament, *Written Answer S2W-9478*, 30 June 2004

REMIT OF THE LOCAL GOVERNMENT FINANCE REVIEW COMMITTEE

To review the different forms of local taxation, including reform of the Council Tax, against criteria set by the Executive, to identify the pros and cons of implementing any changes to the local taxation system in Scotland, including the practicalities and the implications for the rest of the local government finance system and any wider economic impact, and to make recommendations.

<u>Core issues for systems of local taxation</u>
The issues that the review will need to examine for each system are:

- Effect on the economy/economic growth;
- Ability to pay/fairness;
- Ease of avoidance/collectability;
- Stability/predictability;
- The relationship to the Benefits system;
- Balance of Funding;
- Buoyancy;
- Accountability;
- The cost of collection;
- Who collects the tax;
- Shift to a new system: timing and transitional arrangements.

<u>Systems to be examined</u>

- Council Tax (current and reformed);
- Local Income Tax (locally and nationally set);
- Land Value Tax;
- Options for local business taxation;
- Any other appropriate models.

<u>The associated issues to be addressed</u>
The associated issues are:

- Business rates;
- The impact on the current GAE/RSG system;
- The mechanism for distributing grant between authorities;
- The relationship to domestic Water and Sewerage charges;
- Reserved issues.

6. In conducting the review, we have taken the existing UK tax system and the present Scottish devolution settlement as givens.

7. We have also considered whether we should restrict the scope of our review to matters that lie within the competence of the Scottish Parliament or whether we should make recommendations on reserved matters (such has the operation of the Council Tax Benefit scheme and composition of the UK basket of taxes). Since we are making recommendations to Scottish Ministers, we have concluded that it would not be appropriate for us to make recommendations on issues that lie outwith the competence of the Scottish Parliament.

CONDUCT OF THE REVIEW

8. From the start of our review, we have recognised the need to give everyone with an interest in the future of local taxation in Scotland the opportunity to participate in the debate.

Consultation paper

9. We started by scoping the debate and, in particular, identifying issues we needed to consider more closely. In January 2005 we published a consultation paper which sought views on all aspects of our remit. We made the consultation paper generally available through our website and we distributed copies to a variety of stakeholders with a potential interest in the review, including local authorities, local government bodies such as COSLA[6] and SOLACE (Scotland),[7] MSPs, political parties, business organisations and welfare interests. We also encouraged public participation in the consultation by placing advertisements in the local and national Scottish press inviting people to visit our website or to contact us for their own copy of the consultation paper. In total, we issued around 1,600 copies of the consultation paper.

10. The Committee received some 350 responses by the end of the consultation period. Around 290 were from members of the public and approximately 30% of these described themselves as pensioners. In addition to these replies, Help the Aged ran a postcard campaign. The pre-printed postcards asked the Committee to consider carefully the effect of local taxation on pensioner households with low or fixed incomes. We received around 450 of these postcards. We also received 13 copies of a petition calling for the introduction of a local sales tax in place of council tax. Overall there were just over 100 signatories to this petition. A feedback paper about responses to the consultation, published in July 2005, is available on our website.

Public survey research

11. Recognising that the responses were self-selected and therefore the submissions received from the consultation process would not necessarily reflect the views of the population of Scotland as a whole, we also decided to obtain a more detailed and representative impression of public opinion towards local taxation across Scotland. We commissioned two distinct and complementary pieces of public survey research. Both research reports are available on our website.

6 The Convention of Scottish Local Authorities

7 The Society of Local Authority Chief Executives and Senior Managers (Scottish Branch)

12. The first report was a representative sample survey of public understanding of, and attitudes towards, local government funding in Scotland. For this purpose we commissioned a module of 10 questions in MORI Scotland's Social Policy Monitor. MORI Scotland interviewed 1,017 adults across Scotland between August and October 2005 and MORI weighted the results to ensure the data were representative of the population.

13. The second report was qualitative research, in the form of deliberative focus groups. Although not intended to be a representative analysis of public attitudes, this research helped us to understand the extent of public understanding of local government funding and the reasons for people's attitudes towards different local taxation models. This research, conducted by GfK NOP, involved 75 participants spread over 8 deliberative focus groups held in locations across Scotland in October 2005.

Oral evidence sessions

14. We also held a series of oral evidence with a range of stakeholders. These included many local authorities,[8] COSLA, CIPFA in Scotland, SOLACE, CBI Scotland, the Scottish Chambers of Commerce, the Federation of Small Businesses in Scotland, six political parties,[9] Help the Aged in Scotland and UNISON. We recorded transcripts of these oral evidence sessions and these transcripts can be found on our website.

"Proofing" discussions

15. We held a number of fact-finding discussions with certain stakeholders, including Citizens Advice Scotland, the Department of Work and Pensions, HM Revenue and Customs, the Scottish Assessors Association and Scottish Water, in order to test and assess the practical effects of potential approaches. We also met three times with Sir Michael Lyons, who has been undertaking an inquiry covering similar ground in England.

Modelling research

16. We commissioned research to model the effects of a range of possible local taxation options. Following a selective tendering process, we appointed the University of Stirling to conduct this work. Their report is available on our website.

Legal advice

17. We appointed Brodies LLP to provide legal advice on a range of issues.

8 All councils that submitted written responses to our consultation were invited to give oral evidence

9 The Scottish Conservative Party, Scottish Green Party, Scottish Labour Party, Scottish Liberal Democrats, Scottish National Party and Scottish Socialist Party

CONSTRAINTS ON THE REVIEW

18. The Committee are satisfied that we have been able to obtain evidence that enables us to respond to each aspect of the remit that Scottish Ministers set for us. However, we should record two areas on which the evidence available has been more limited than we would have hoped, namely statistical evidence and evidence of economic and behavioural effects.

Statistical evidence

19. A major problem for the Committee has been about finding suitable statistical evidence. Many of the statistics which one might have wanted simply are not available. For example, HM Revenue and Customs have statistics on incomes for individuals. The Family Resources Survey produced by the Department of Work and Pensions provides valuable information on incomes and other details, at household level. None of these statistics provide exact details of the value of the properties occupied by those individuals and households.

20. Notwithstanding the problem with data and the consequent strength of the conclusions drawn from them, the Committee have had the benefit of professional statistical advice from the University of Stirling and from the Analytical Services Division within the Scottish Executive's Finance and Central Services Department. We are satisfied that overall we have used the best available statistics and evidence to meet our remit, though we acknowledge that the incompleteness and limited compatibility of some of the statistics means that these results should be considered as broadly accurate rather than definitive. We do not consider this a significant problem. Given the economic dynamics, it is likely that the figures will have changed before any possible implementation date. Consequently we are happy that our conclusions are broadly supported by the data.

Evidence about economic and behavioural effects

21. One of the criteria our remit asks us to consider is the effect of different tax systems on the economy. Our wish has been to identify and quantify the effects of various options on people's behaviours and, consequently, on the economy.

22. We have found evidence about the types of impacts that could arise from the introduction or withdrawal of different tax systems, which have given us a reasonable understanding about the effects of change in theory. However, translating the theory into quantifiable effects of particular changes to the local tax system in Scotland has proven extremely challenging. Effectively, we have been trying to predict likely behavioural responses which will be dependent on or influenced by a number of factors, including the nature of the current council tax system, the particular features of any particular reforms or replacement tax system, and other specific social, economic and demographic factors that are unique to Scotland. We have been unable to translate empirical evidence of experiences in other countries, each of which has its own unique circumstances, into quantifiable predictions for Scotland.

SECTION 3:
HISTORY OF LOCAL GOVERNMENT FINANCE IN SCOTLAND[10]

THE POOR LAW OF 1579

1. The origins of local taxation in Scotland are to be found in the Poor Law of 1579, which made provision for the poor of the parish a legal obligation. Previously, provision for the poor had been made almost wholly by charitable contributions through the church authorities.[11] Previously towns had been created Royal Burghs, with the right to collect dues for the provision of infrastructure, and the common good, from court fines, petty customs and lands given to the Burghs by the King. There was no system of local administration as such.[12]

2. From 1579 and for nearly three hundred years of minimalist government, local rates provided the basis of local services. The parish rate provided the starting point, which assessed all inhabitants of the Parish according to their "means and substance", and was levied on both owners and occupiers of property. Boyle[13] interpreted this approach as what we today would call ability-to-pay, although it considered both income and wealth.

3. There was no uniform system of assessment, and the tax encompassed personal belongings as well as immovable and moveable property. Moreover, eligibility to pay and the form of assessment varied with different rates. Local services for poor relief, public health, roads, police and education, each had separate rates. For example, the sewer rate was levied on owners of property, the Burgh assessment on occupiers, and the lunatic asylum rate on both.[14] But although there was no uniform system, the underlying concern of means and substance was to reflect ability to pay. This use of separate rates within ad hoc systems of local administration relied on very rough assessments of income.

DEVELOPMENTS IN THE 19TH CENTURY

4. After the extension of the franchise in the 1832 Reform Act, a process of modernisation and consolidation began, in terms of both the structure and finance of local administration. From 1845, parish rates were levied only on immovable property, based on net annual rental value, the beginning of the 20th century rating system. This still assumed, however, that the valuation of property was a reasonable proxy for ability to pay, in a period of very limited franchise open only to the property owners. This system was formalised in the Lands Valuation (Scotland) Act, 1854, with the valuation roll being prepared annually. This legislation still forms the core of valuation law today.

5. This Act set an important principle, namely that the rental basis of valuing property "was originally introduced as a method of estimating the income of property owners", but "not necessarily related to the income of the resident".[15] This distinction between owners and occupiers continued in Scotland until 1956.

10 The Committee commissioned Professor Arthur Midwinter to produce a paper describing the history of local government finance in Scotland. This section provides a summarised history. This is almost entirely drawn from Professor Midwinter's paper, which is available on our website

11 Boyle, *Equalisation and the Future of Local Government Finance* (1966)

12 McConnell, The Politics and Policy of Local Taxation in Britain (1999)

13 ibid

14 Midwinter, *A Return to the Ratepayer Democracy? The Reform of Local Government Finance in Historical Perspective*, Scottish Economic and Social History, Vol.10 (1990)

15 Boyle, ibid

6. The process of consolidation of the separate rates was a gradual one, and finally completed in the Local Government (Scotland) Act 1929. The other major development, predating this merger by over a hundred years, was the introduction and growth of central government grants to local authorities.

7. The 19th century witnessed the growth of industrialisation and urbanisation, creating new pressures on government, and the beginnings of the shift from minimal government to modern government. For local government, its fiduciary duty as the trustee of public funds was established as its scope grew in terms of its service responsibilities.

8. During the 19th century, grants from central government grew steeply and steadily, following the first such grant for prisons in 1825. The growing dependence on grant reflected "the relative inflexibility of local tax yield arising from its reliance on the property tax as the main source of revenue" (Bennett, 1982, p.43). By the end of the 19th Century, there were grants for police, education, housing, roads and relief for the Highlands.[16]

9. These are known in the language of public finance as specific grants (or categorical grants in the USA), as they are tied to specific programmes. Specific grants can require matching funds from the local authority, and are used to stimulate and foster service development. This growth reflected the strain on local rates as the expansion and the range of services provided increased. The result was that central government became the driving force of development, taking the financial and legislative initiative in planning and regulating services and spending, whilst local government became the major mechanism of service provision.

10. Much of this expansion took place in the form of permissive legislation, which left discretion with local government. It was during this period of development that arguments between "centralists" and "localists" emerged. By 1880, central support had doubled from 4.5% to 9.8% of local expenditure. Localists favoured local control as a way of limiting government whereas centralists favoured increased central power to promote uniform services. In practice, the permissive nature of the statutory obligations facilitated variations and low spending in rural areas. The argument between "centralists" and "localists" continues to this day.

11. These developments were recorded in the Goschen Report on Local Taxation in 1870. It demonstrated that, whilst rateable values had risen by 200%, local taxes had increased by only 135%, thereby reducing the tax burden, in part by substituting central grants. Indeed, rates had actually fallen in some rural areas. Goschen favoured consolidated units of local government, uniform valuation methods, and the allocation of assigned revenues in place of specific grants to increase central control over expenditure totals.

16 Midwinter, ibid

12. HM Treasury disliked the "open-ended" nature of specific grants, as grants reflected local decisions to spend. However, assigned revenues had similar effects and by the end of the 19th Century, all major local services were again funded by specific grants with a fixed percentage of support, a development which again fostered service expansion. By 1920, grants' share of spending had increased to 24%.[17] But the distribution of grants had become problematic, being described as "a chaos which practically no-one understands".[18] Grants in the UK had grown from £500,000 in 1842 to £20m by 1900, and further still to £110 million by 1928 – nearly 16% of government revenues.[19]

13. These 19th and early 20th century developments mark the beginning of the current "Balance of Funding" debate, as local government finance grew not only in absolute terms but in relative terms also, as its share of the UK Government's spending also increased. Moreover, the Royal Commission on Local Taxation of 1901 began a new debate on how grants should be distributed between authorities on the basis of need.

THE LOCAL GOVERNMENT (SCOTLAND) ACT 1929 AND POST-WAR DEVELOPMENTS

14. This legislation is significant for a number of reasons: first, it is exceptional in that issues of structure and finance were considered together – in contrast with the subsequent reviews of structure which dealt with either in isolation. Second, it was the first application of a Scotland-wide system of equalisation (an expansion of the scheme to provide relief in the Highlands to support the lack of fiscal capacity which had been implemented in 1888). Third, it consolidated both structures and finance in a system with fewer local authorities, and fewer government grants.

15. The 1929 Act sought to reduce the burden of rates, both on industry and more generally, by substituting central grant. In the case of equalisation, it developed the grant system to reflect both fiscal capacity – the authorities' ability to raise funds – and spending needs – the necessity to incur expenditure on the service assessed. It reflected the relatively high levels of needs and low tax bases in Scotland's cities and remote rural areas, relative to her towns and suburbs. Local authorities also had responsibility for national assistance and hospitals, so the fiscal capacity issue was a real one. The General Exchequer Contribution (GEC) was still supported by a range of special grants. The Act also completed the process of derating agricultural land and buildings to provide an economic stimulus to that sector.

16. This new block grant approach was further developed in the post-war period, to cope with the rapid rise in expenditure following the establishment of the British Welfare State. The GEC had also been regarded as a mechanism which facilitated local discretion, a recurring argument in governmental pronouncements in the post-war period.

17 McConnell, ibid

18 Webb, *Grants-in-Aid* (1920)

19 Foster, Jackman and Perlman, *Local Government Finance in a Unitary State*,(1980); figures quoted are nominal.

17. The introduction of the Exchequer Equalisation Grant (EEG) was accompanied by the transfer of responsibilities for national assistance, hospitals, gas and electricity to central government. The EEG was calculated on the basis of rateable values, with grants paid to authorities whose yield fell below a standard level, and the residual element after equalisation was allocated on a per capita basis. The EEG was examined in Scotland in 1955 by the Committee on Valuation and Rating, chaired by Lord Sorn, but it was mainly concerned "with the adequacy of the formula for determining local grant to Scotland",[20] which in itself reflected the Goschen Formula – the predecessor to the Barnett Formula.

18. The second stage of reform came in 1957. By this time, the grants system, with its many elements, had become extremely complex. The 1957 review sought to strengthen the rating system and in fact rejected a proposal from the Royal Institute of Public Administration for a local income tax, on grounds of administrative cost and practicality in terms of the technology of the time. The Review reduced the de-rating of industry from 75% to 50%, thereby expanding the tax base, and included education in the block grant. The EEG was renamed the Rate Deficiency Grant, and the enlarged block grant element became a new General Grant.

19. The cumulative effect of these changes was to promote expenditure growth through grants, and reduce the proportion of local government finance raised through rates. Until the 1960s, ratepayers had been sheltered from spending increases by central support in the form of grants. Rapid growth with increasing inflation resulted in substantial rises in local taxation.

20. The final stage in the consolidation of the grant system arrived in the introduction of the Rate Support Grant in 1967. Rates increases had stimulated protest following the revaluation in England in 1961. Local spending was consuming a growing share of the national budget, as new responsibilities were added. Revaluation involves shifts within the range of tax liability, and in 1961, this varied from a decrease of 17% to an increase of 68%. Public protest was marked.[21] The Allen Committee was set up to examine these pressures, and reported in 1965. Research carried out for it showed rates to be a highly regressive tax which took up more of the household income in poorer families than in wealthier households (Allen Report, p.134).

21. The Allen Committee had also highlighted the clear nature of rates – as a <u>tax</u> which funds services which bring benefits to communities which are indivisible by nature, and which also bring national benefits as well as local benefits. Whilst rates had begun as a tax which broadly reflected ability-to-pay, it now was more accurately regarded as a tax on the consumption of property, and its inelastic nature constrained the scope for consistently increasing it to fund new expenditure.

20 Boyle, ibid

21 *Local Government Chronicle* (23rd March 1963)

22. The Government dealt with the burden on poor households by introducing rates rebates, in recognition of the fact that rates were part of core housing costs, and funding through benefits would reflect that. Much of the protest from ratepayers, however, came from middle class households, and this was responded to by introducing a new domestic element which had the effect of a general reduction in domestic rates. Fiscal capacity and expenditure needs were dealt with through the resources element and the needs element. Protest receded temporarily, but the combination of high inflation with local government reorganisation led to a further crisis during 1971-74. In Scotland, grant was increased again, to the point of accounting for 75% of spending, and a further review was established.

THE LAYFIELD REPORT 1976 (LAYFIELD)

23. The mid-1970s saw a period of widespread UK public protest and ratepayer complaints following dramatic increases in rate bills. Oil prices had risen steeply in 1973 and inflation was running at over 20%. In Scotland, many households had faced significant increases in their rates bills following the revaluation of 1973 combined with the 1975 reorganisation of local government, as a result of which low tax areas were merged with high spending cities in the new Scottish regions, while the old authorities ran down balances, spent common good funds and entered into new spending commitments in their final year.

24. In the midst of such discontent, the Government established a Committee of Inquiry into Local Government Finance in 1973, chaired by Frank Layfield Q.C, and gave a commitment to replace rates with more broadly based taxation related to ability to pay.[22]

25. Layfield has been described as "the most comprehensive review of local government ever produced"[23] and "a benchmark for subsequent studies".[24] Yet as two of its distinguished members wrote recently, this is perhaps ironic as its central recommendation – the need to clarify responsibility and therefore accountability for local expenditure and taxation – was rejected by the government of the day, and only its more practical proposals were implemented.[25]

26. Layfield proposed to retain rates and block grant as core elements of the system, and concentrated its argument on the balance of funding issue. It identified a centralising trend in local government finance. The result of this trend was a drift to central responsibility and a weakening of local government, because of the growth of grant within the total of local funding, a drift which Layfield felt was incompatible with responsible local government.

22 McConnell, ibid

23 Richards, *The Recent History of Local Fiscal Reform*, in Paddison & Bailey (eds) "The Reform of Local Government Finance in Britain" (1988)

24 Bennett, *Central Grants to Local Authorities* (1982)

25 Jones and Stewart, *Central-Local Relations Since the Layfield Report*, Local Government Studies, Vol.28, No.3 (2002)

27. Layfield favoured a localist model, concluding that the only way to sustain a vital local democracy was to enlarge the share of local taxation in local authorities' revenue and thereby make councillors more directly accountable to their electors for their spending and rating decisions. Its proposal at the time was to reduce the percentage of grant support from 60% to 40%, which it assumed would clarify that responsibility for setting the pace and direction of service development, expenditure and taxation lay with local authorities, reversing the trend of the previous hundred years.

28. Layfield favoured a change in the balance of funding by introducing a local income tax as a supplement to rates. This would result in a more progressive and broad-based local tax system with greater independence from the centre and as a result, a greater degree of local accountability. Layfield regarded local income tax as the only serious candidate for a new source of local revenue.

29. The Layfield Report remains an influential document today, and current researchers still acknowledge it and feel the need to address its arguments.

THE LOCAL GOVERNMENT (MISCELLANEOUS PROVISIONS) (SCOTLAND) ACT 1981

30. In the light of the larger economic and financial crisis facing the United Kingdom in the aftermath of the OPEC[26] price increase of 1973, and the subsequent International Monetary Fund loan to the UK Government in 1976, the public expenditure philosophy shifted from expansion to retrenchment. To control local government expenditure, the Treasury introduced cash limits to the amount of grant paid to councils. In Scotland, a system of current expenditure guidelines was introduced in 1977, which set an indicative overall target for each local authority.

31. The 1980s marked a further shift in emphasis away from the control of local government in the aggregate to a concern with the spending of individual councils, a concern reflected in the passage of the Local Government (Miscellaneous Provisions) (Scotland) Act 1981.

32. In 1979, the Scottish Office had set a testing 7.5% target for spending reductions, with the prospect of further reductions in later years. This had led to widespread opposition across political parties in local government. The target was revised to a more realistic 2.3%, though much of this was achieved through savings in capital spending. In 1980, inflation at the high level of 22% resulted in major increases in rates bills, averaging 30%. In real terms, the spending targets were modest, but in cash terms, they created substantial public resentment.

33. The Government took the view that high spending had caused the rates increases, and that the problem was mainly the result of the decisions of a few authorities. Significantly, however, the 1980 budget decisions led ministers to seek a more discriminatory set of policy instruments for influencing local decisions than the conventional adjustments to the level of grant support.

26 The Organisation of the Petroleum Exporting Countries

34. The legislative changes introduced in 1981 were opposed by local authorities who presented them as a challenge to their historic right to set their own expenditure and rate levels. The Act created powers of selective intervention against individual councils, and drew upon an existing statutory power from 1966. The Secretary of State for Scotland, if satisfied that the expenditure of a local council was "excessive and unreasonable", could seek parliamentary authority to effect a reduction of its Rate Support Grant. The 1981 legislation further amended and updated this power, so that it could be used prospectively.

35. The main target was Lothian Regional Council, who imposed 40% rates increases two years in succession, and adopted a high profile stance of political resistance. The savings from the Government's action, which became known as ratecapping, were around £30 million per annum, about 20% of the "overspend", and 2% of total local authority spending. Although the use of capping was limited, its availability caused a deterioration of relations between central and local government, and its existence would have constrained decisions by most authorities.

36. At the same time, the Government continued with the conventional approach of reducing the percentage support paid by grant, from 68.5% to 61.7%, and this trend continued until 1988 89, by which time it had fallen to 52.2%. The figures for this period reveal how sensitive rates levels are through the gearing effect and the inelasticity of the rating system. This difficult and complex situation was further compounded by revaluation in 1985.

COMMUNITY CHARGE (THE POLL TAX)

37. In 1986, the Government published its Green Paper "Paying for Local Government". It was this Green Paper which paved the way for both the nationalisation of non-domestic rates and the introduction in 1989 of the Community Charge.

38. Previous reforms to the rating and grant system had been concerned with improving the equity of the system. The Green Paper's analysis suggested these reforms had failed, because the form of local taxation did not provide sufficient incentive to electors to restrain council spending. The central argument in the Green Paper was the need to strengthen local accountability by tackling the weaknesses of the current system. These were:

- The high proportion of local taxation raised from non-domestic ratepayers to whom, not having any votes, councils were not answerable;
- The fact that only a minority of electors paid rates, and that bills did not reflect the variations in households' consumption of local services; and
- The grant system was complex and blurred accountability for local spending decisions.

39. The recommended alternative to domestic rates was a per capita community charge, which became commonly known as the poll tax, which the Green Paper argued would provide a closer reflection of modern people-based services than a property tax. The link between voting, paying and spending would be strengthened by converting non-domestic rates (NDRs) into a nation-wide tax, set and controlled by central government and distributed to authorities via the grant system, although it was collected still by the local authorities.

40. This Non-Domestic Rate Income (NDRI) element formed part of a new financial framework for local government. Central government set total levels of Government Supported Expenditure (GSE) each year. This was supported through Aggregate External Finance (AEF), which was composed of Revenue Support Grant (RSG) and Specific Grants, as well as NDRI.

41. In practice, this was intended to be a system of accountability at the margins. All marginal spending decisions would be funded by local taxpayers, thereby directly linking higher spending (i.e. any spending above the assessed expenditure need figure for which grant is payable) to higher tax bills. This would discourage electors from voting for "higher service standards than they would be prepared to finance if they bore the full marginal cost themselves" (Green Paper, p.38).

42. The community charge was introduced to Scotland in 1989 (one year earlier than in England and Wales), following the passage of the Abolition of Domestic Rates, etc (Scotland) Act 1987. The shift in tax unit from household to individual increased the volume of transactions, adding to the costs of collection. The requirement that each individual had to pay at least 20% of the tax – even though compensated directly through benefit – made the administration of rebates more complex and the costs of collection and recovery increased.

43. The community charge was very unpopular. It was expensive and difficult to administer. Collection costs rose from £14 million under rates in 1988 89, to £43.5 million by 1990 91. By January 1990, 421,400 cases of non-payment were being pursued, leading the Accounts Commission to describe the reform as "the single greatest administrative upheaval" local government had faced since 1975.[27] The implementation of the new tax system resulted in spending growth rather than the anticipated expenditure reductions.

44. In 1990, the Government responded to the crisis in local government finance by increasing grant in order to reduce poll tax bills, specifically through an increase in VAT.[28] This reduced the proportion being met by council taxpayers to an average of around 15% across Scotland. The Government proposed broadly to maintain that level under the community charge, and to ensure that extra support from central funds resulted in lower bills, not higher expenditure.

27 Accounts Commission, T*he Community Charge in Scotland: The First Year in Operation* (1991)

28 Gibson, *The Politics and Economics of the Poll Tax – Mrs. Thatcher's Downfall* (1990)

THE COUNCIL TAX IN THE 1990S

45. The 1991 Consultation Paper "A New Tax for Local Government" attempted to take a pragmatic approach towards establishing an acceptable tax and strengthening central control. The central argument was to maintain a degree of local accountability whilst protecting local taxpayers from excessive bills.

46. Although fairness was identified as an underlying principle, this was not perceived simply in terms of ability-to-pay, but in "most adults making some contribution" (p.2), and in trying to ensure that public perception was that the system was fair. The argument that all electors should pay something towards the cost of local services was dropped in favour of a tax which would take account of most adults in a household with a reduction for single-person households, with the tax varying within a limited range according to property values. In practice, council tax is in effect a property tax with a 25% discount for single-person households. The operation of a banding system with an upper limit prevents very high bills falling on a minority of properties, and meant there was less need for regular and frequent valuations of properties.

47. Other elements of the previous system remained, in terms of non-domestic rate income and the grant system. Grant would continue to be paid at a level consistent with the Government's assessment of an authority's need to spend to provide a standard level. Spending above this level at the margins would be reflected in higher household bills, whilst the benefits of spending below the standard level would fall to households.

48. The transition to council tax was smooth. There were several reasons for this. Firstly, the council tax model removed many of the administrative problems of the community charge. The number of bills was reduced, the full payment of benefits direct to councils restarted, and the need for a register of taxpayers removed. The volume of enquiries regarding total taxes fell, and the level of appeals under banding fell in comparison with rates.

49. In 1993, the electorate appeared to support the change to council tax[29] as reflected in councils' dealings with the public. Correspondence with complaints from local taxpayers to council finance departments was halved, and much of such correspondence raised community charge non-payment rather than council tax itself. Elected members, who had ensured that action to implement the community charge had been delayed to the last possible moment with the law, now provided those resources needed for implementation. Collection rates improved rapidly, from 87% in 1992-93, to 95% by 1995-96 with provision for bad debts reduced from £490 million in 1992-93 to £81.6 million in 1995-96. Such objections as there were concentrated on the discount arrangements, and the upper banding limit.[30]

29 Midwinter and Monaghan, *The New Centralism: Local Government Finance in the 1990s*, Financial Accountability and Management, Vol.11, No.2 (1995)

30 Midwinter and McGarvey, *The Reformed System of Local Government Finance in Scotland*, Policy and Politics, Vol.25, No.2 (1997)

50. The Government's combination of tight capping limits with new provision for efficiency gains reduced "overspending" in the short run, from 5.4% in 1990-91, to a low of 1.3% in 1992-93; thereafter it began to grow again, reaching 4.6% in 1996-97, the first year of local government reorganisation. In the first four years of council tax, grant fell by around 2.5% per annum, whilst council tax grew by around 1.5% per annum, in real terms.[31]

51. However, reorganisation of local government in 1996 led to a new source of instability in local government finance. As the new authorities set their first budgets, there was an exceptional last-minute intervention to provide additional funding support of £100 million, to alleviate spending reductions and cushion increases in council tax.[32]

52. The revised financial framework established under the community charge was continued in the reformed system. In 1996, RSG, Specific Grants and NDRI together provided 87% of GSE, with 13% raised through council tax.

53. Whilst central government increased the level of grant support in the early years of council tax, by 1993-94, it had returned to grant restraint, which in real terms fell from £5.69 billion in 1992-93 to £5.43 billion in 1995-96, whilst council tax rose from £558 at Band D to £784. Over this period, the share of local government spending funded by government fell by 4.5%, with council tax rising by 17% in real terms.[33]

54. The change of government in 1997 brought a gradual return to grant increases in the Comprehensive Spending Review of 1998 (HM Treasury, 1998), the abolition of universal capping controls on spending, and a slow rise in spending and council taxes.

55. The Devolution White Paper[34] stressed the importance of local government spending in the devolved powers, and the need for clear lines of accountability over local expenditure and taxation. Whereas in the past consistency of approach had been delivered through policy uniformity within the UK, the impact of devolution on local government finance within the Treasury's framework of financial control was more complex. The financial arrangements limited the extent to which Council Tax Benefit could be increased and provided for the UK Government to take account of any excess growth in locally financed expenditure over the national trends in the Scottish Budget.

56. The Labour Government decided that any reform of local government finance should be a matter for the new Scottish Parliament to determine. In the interim, increases in non-domestic rates would be restricted to inflation, whilst universal capping would be removed. The Government established the Commission on Local Government and the Scottish Parliament, chaired by Sir Neil McIntosh, in 1998 to review central-local relations, but excluded finance from its remit.

31 Midwinter and McGarvey, ibid

32 Midwinter, *The Fiscal Crisis in Scottish Local Government, Local Governance*, Vol.24, No.1 (1998)

33 Midwinter, ibid

34 The Scottish Office, *Scotland's Parliament*, Cm 3658 (1997)

57. Nonetheless, the McIntosh Commission did make a number of comments about local government finance in its Report. It recorded that it had been told repeatedly that "a reform of local government finance was essential in order to ensure responsive and responsible local government and healthy local-central relations" and that the present arrangements had been criticised on a number of grounds. Those grounds were, in summary, as follows:

- Increased central control of formerly local decisions – namely, centralisation of business rates and council tax capping – had "removed from councils the discretion to decide on behalf of their local electorates where the balance should be struck between levels of service and levels of local taxation". The Report suggested that this loss of discretion was "widely regarded as having undermined the democratic credentials of local government and contributed to public apathy about local government".
- An 80% (central) and 20% (local) balance of funding and the consequent council tax gearing effect produced by this balance. The Report stated that this balance was "heavily criticised" and argued that the gearing effect severely limited councils' discretion on spending and taxation levels.
- The "obscurity of the system" exacerbated the above problems. The Report made the point that many members of the public assumed the council tax paid for local services and could not understand how service levels could be static or fall at the same time as there were large increases in council tax levels. It was argued that this led to a "natural tendency for local and central government each to blame the other … for rises in council tax".

58. The Commission shared those concerns and thought it was "vital for local democracy that ways are sought of responding to them". However, the Commission also thought that there were features of the local government finance system which should be preserved. The first was that the local taxation base and the authorities' spending needs an equalisation process to make possible common standard of services. The second was the principle that Government grant is un-hypothecated so that councils' spending priorities are not dictated through the grant system.

59. Having regard to its own remit – namely, "to consider how councils can best make themselves responsive and democratically accountable to the communities they serve" – the Commission contended that it would be better if councils could raise a "much higher proportion of revenue locally". The Commission recorded the conflicting views of local government and Scottish business on the question of whether or not control of business rates should be returned to local government and suggested that there should be a wide ranging debate on this matter which, amongst other things, took into account the shared interest of both sides in the health of the Scottish economy. But the Commission made clear it was "convinced that in the long term the proportion of revenue raised locally needs to be increased substantially".

60. The Commission recommended that "an independent review of local government finance should be instituted immediately" and suggested that the financial provisions of the European Charter of Local Self-Government might provide a useful starting point for such an inquiry.

61. The Scottish Parliament inherited a system of local government finance which had been reformed only six years earlier, and which had retained the high level of grant support introduced with the community charge, and the needs-based formula for grant distribution. It had also inherited the recommendation from the McIntosh Commission that there should be an independent inquiry into local government finance in Scotland.

SECTION 4:
LOCAL GOVERNMENT FINANCE IN SCOTLAND TODAY

INTRODUCTION

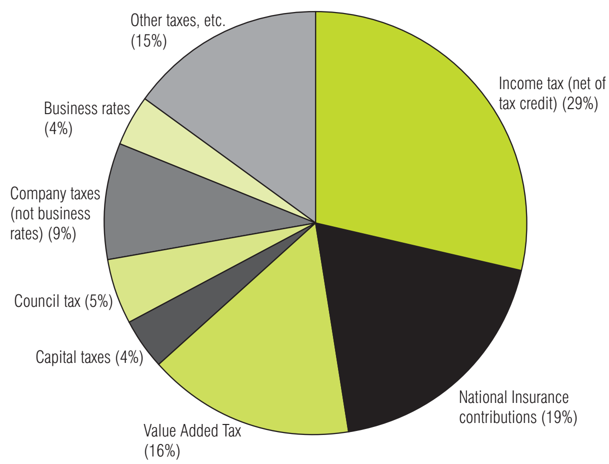
1. Since 1996, there have been 32 local authorities in Scotland. There is a wide variation in the population, area and character (urban and rural) within the 32 authorities. Populations range from 578,790 in Glasgow to 19,590 in Orkney;[35] and areas range from Dundee City Council covering 5,983 hectares, to Highland Council spreading across 2,565,934 hectares.

2. This section sets out fact and figures about local government finance in Scotland, and comparative information about how local services are financed in other countries.

LOCAL GOVERNMENT EXPENDITURE

3. Public services are paid for through a mixture of taxes, duties and charges. In 2005-06, an estimated total of £486.1 billion was raised in the UK. This included £21.0 billion from council tax and £20.3 billion through non-domestic business rates.

Figure 4.1: UK Tax Revenue[36]



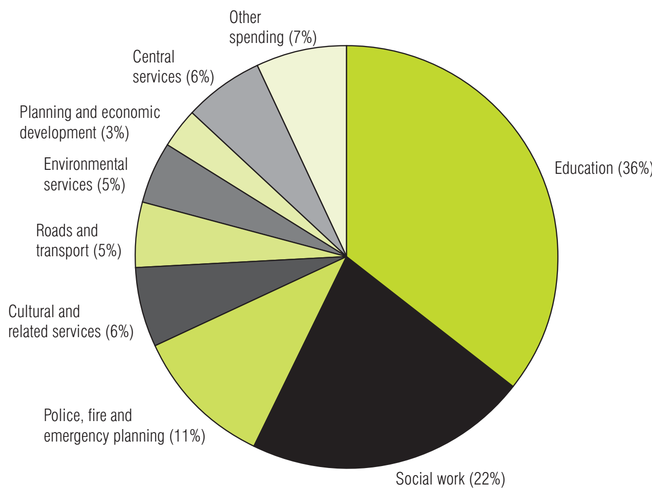
4. Total general fund expenditure by Scotland's local authorities in 2004-05 amounted to £11.7 billion.[37] A breakdown of this expenditure is shown in figure 4.2.

35 General Register Office for Scotland, *Mid-2005 Population Estimates Scotland*.

36 HM Treasury, *Budget 2006*, Table C8 (2006); excludes North Sea revenues.

37 Scottish Executive, *Scottish Local Government Financial Statistics 2004-05,* Table 3 (2006): this figure excludes housing and other services which are funded separately, and also capital expenditure.

Figure 4.2: Expenditure by local authorities in Scotland in 2004-05



LOCAL GOVERNMENT FUNDING

5. Funding for local government comes from four principal sources:

- Scottish Executive support (Revenue Support Grant and other grants);
- Non-domestic rates;
- Council tax (including rebates through Council Tax Benefit); and
- Fees and charges.

Scottish Executive funding (including non-domestic rates)

6. The Scottish Executive estimates what the total amount that all local authorities require to meet their commitments. The relative spending needs of authorities are assessed by what is known as the "client group" methodology which allocates to each of the 32 authorities a share of the Grant Aid Expenditure (GAE) total. GAE is the Scottish Executive's view of what all the local authorities need to spend on local services to meet their statutory obligations. The distribution of GAE among local authorities takes account of a range of factors which affect spending needs, including:

- Population;
- Population dispersion;
- Pupil numbers (for education);
- Standardised Mortality Rates (for aspects of social work);
- Road Lengths; and
- Measures of the relative deprivation in that area and crime rates.

7. Each local authority receives specific funding through a single large block of funding known as Aggregate External Finance (AEF), supplemented by a range of separate grants. AEF is distributed to local authorities in order to equalise both (a) the relative needs of each authority in incurring expenditure on the provision of local services and (b) the local taxation base. The AEF comprises three components:

- Revenue Support Grant (RSG);
- Specific grants from the Executive, most notable of which is a 51% specific grant on the police service; and
- Income from non-domestic rates (NDRI). Non-domestic rates are set centrally but collected locally by local authorities on behalf of the Scottish Executive.

8. AEF for Scotland's local authorities in 2006-07 amounts to £8.3 billion.[38] This is the equivalent of around 28% of the Total Managed Expenditure of £29.7 billion planned by the Scottish Executive in 2006-07.[39]

The significance of local taxation

9. Although local authorities receive some income from fees and charges, the primary sources of funding are AEF support from the Scottish Executive and income from council tax. In 2004-05, local authorities received £7.7 billion from the Scottish Executive[40] and £2.0 billion from council tax (including council tax rebates).[41] The ratio between Executive support and council tax income was consequently 79.8:20.2, i.e. almost exactly 4:1.

38 Scottish Executive, *Finance Circular 1/2006* (2006)

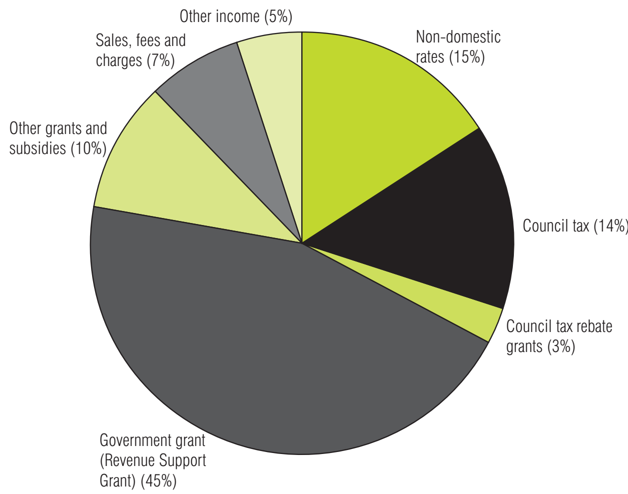
39 Scottish Executive, *Draft Budget 2007-08: Final Review on Spending Review 2002 Targets* (2002)

40 Scottish Executive, *Finance Circular 2/2005* (2005)

41 Scottish Executive, *Scottish Local Government Finance Statistics 2004-05,* Table 2A (2006)

10. Figure 4.3 sets out the composition of local government income in 2004-05:

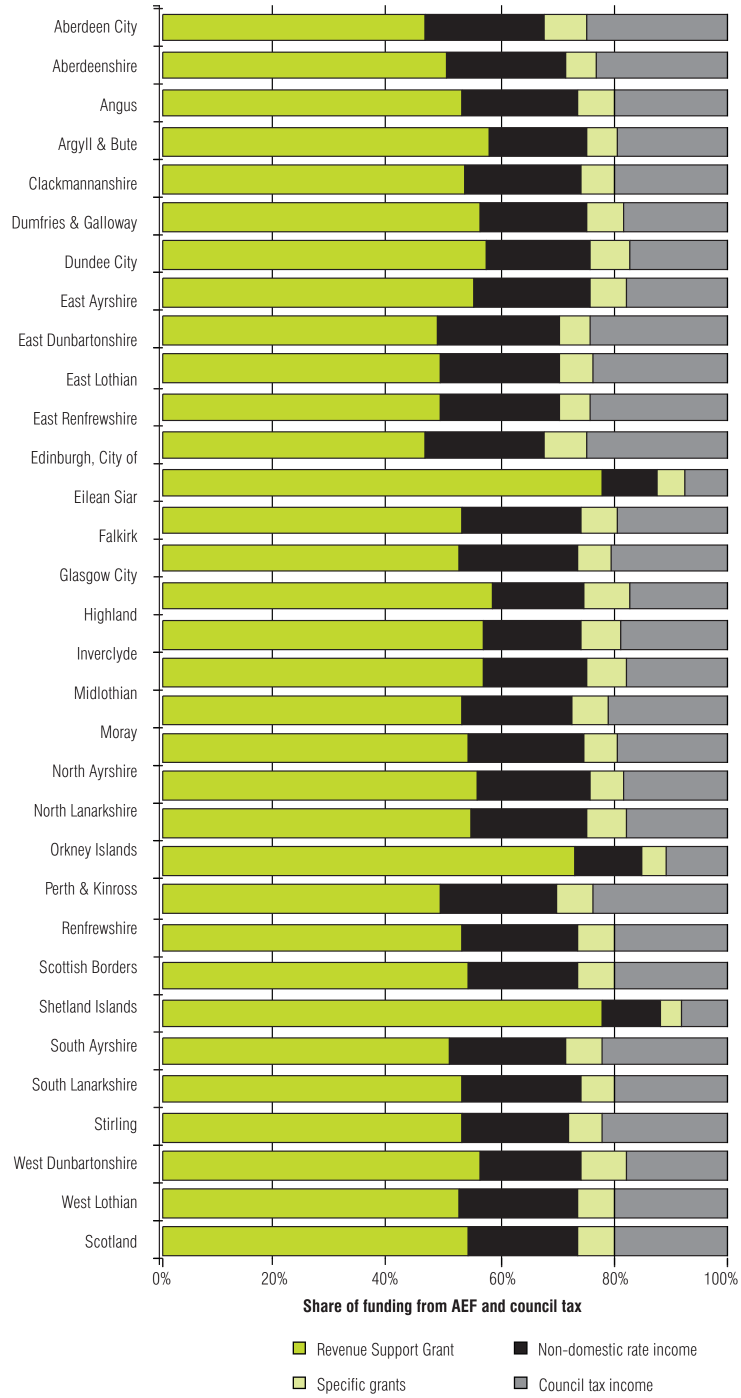
Figure 4.3: Sources of local government income 2004-05[42]



11. However, as the following figure demonstrates, the composition of local government funding can vary greatly from one local authority to another, depending on such factors as the population density of a local authority area, the nature and extent of the local population's service needs and the ability of the local population to contribute towards the cost of these services from local tax.

42 Scottish Executive, *Scottish Local Government Financial Statistics 2004-05*, Table 2A (2006)

Figure 4.4: Sources of local government income 2004-05: Comparison of local authorities[43]



43 Scottish Executive, *Scottish Local Government Financial Statistics 2004-05,* Table 11 (2006); also Scottish Executive Finance Circulars 2/2004 & 2/2005

COMPARISONS WITH LOCAL TAXATION IN OTHER COUNTRIES

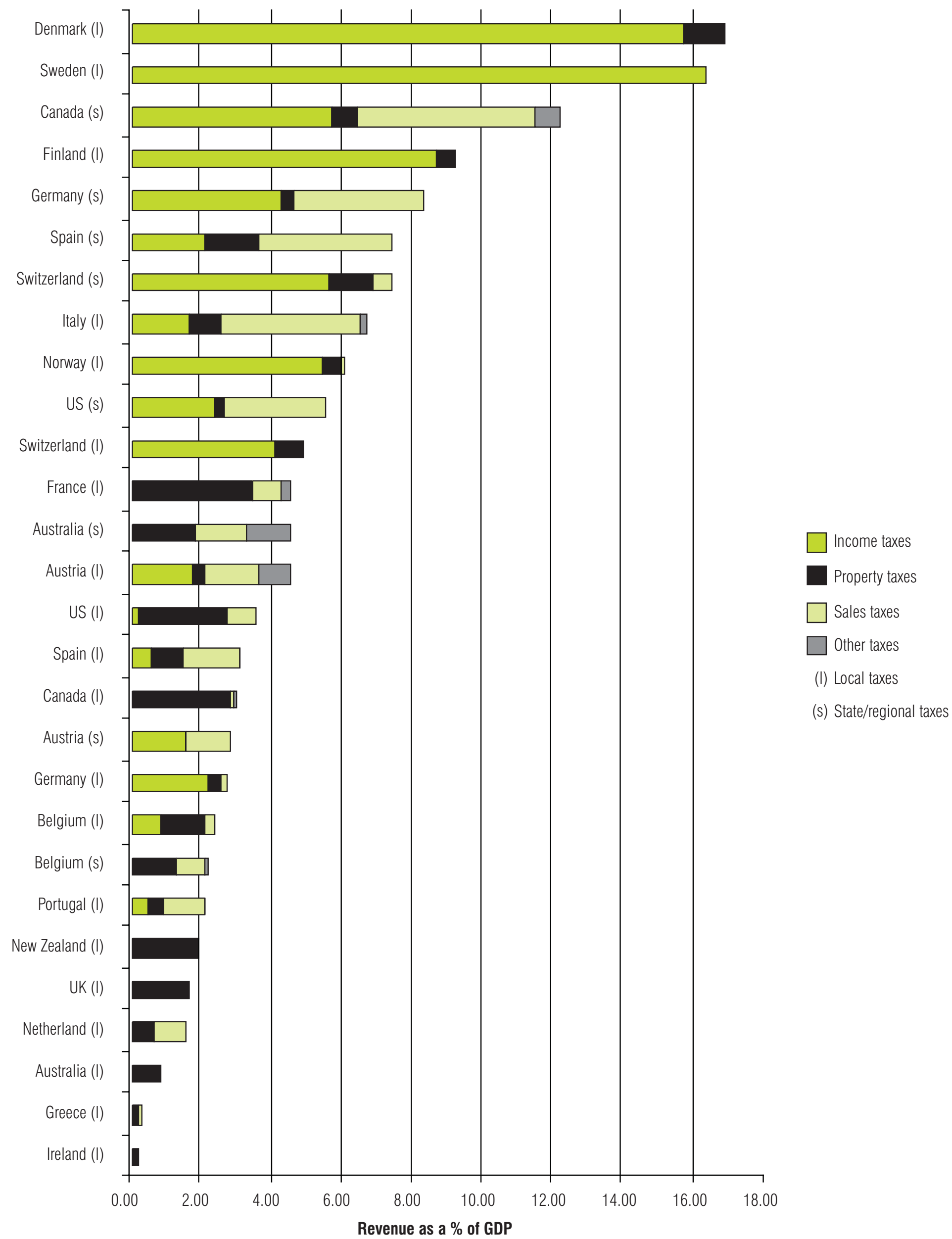
12. Figure 4.5 shows the yields of the main regional and local taxes as percentages of Gross Domestic Product (GDP). The key points to note are as follows:

- Income taxes, property taxes and sales taxes are the most common;
- Local income taxes are of exceptional importance in Scandinavian countries;
- Local property taxes tend to be important in English speaking countries;
- Although local sales taxes are quite common, their form of implementation very rarely allows local authorities any discretion over tax rates.

13. Some countries levy "other taxes" at subnational level. The most common "other taxes" are payroll taxes: these exist in a pure form in Australia, Austria and Canada. Australia's states have yet another "other tax" in the form of licence duties on retail outlets, such as filling stations and liquor stores.

14. It is clear from Figure 4.5 that the highest yielding subnational tax is an income tax. Allowing that some countries operate this tax at both state and local levels, the average yield at subnational level across the 19 countries is about 4.0% of GDP. Perhaps a tenth of this arises from taxes on corporate incomes, but the great bulk of it arises from taxes on individual incomes. Income taxes come well ahead of property taxes, which account for an average of 1.7%. Taxes on goods and services raise around 1.8% of GDP.

Figure 4.5: Sub-national tax revenues by type of tax as a percentage of GDP[44]



44 IMF, *Government Finance Statistics 2006*, data for latest available year, ranging from 2001-04 except for Ireland which relates to 1997

SECTION 5: ROLE AND CONSTITUTIONAL POSITION OF LOCAL GOVERNMENT

OUR STARTING POSITION

1. A number of those submitting evidence to us expressed the opinion that either our review should have been preceded by an examination of the constitutional position of local government in Scotland and the role expected of Scottish local authorities, or that our remit should have included consideration of these issues.

2. It is arguable that, without a constitutional review, there is a danger that the taxation system would be insufficient to achieve financial accountability for decisions taken locally and that local government would become simply the local administration of centrally determined policies. This argument was put forward by the Scottish Conservatives, but they were not necessarily advocating a strong local government case. They argued that a debate on the role and responsibility of local government was urgently needed because, if centrally imposed policy erodes local government to the extent that all that remains is a local administration of the Executive's policies, services might be better returned to central control.

3. Orkney Islands Council argued that it was essential that local government finance was not considered in isolation from the role, functions and, indeed, the concept of local government. Similar views were expressed by SOLACE (Scotland), although SOLACE did not advocate the return of any services to central government control. Instead SOLACE was concerned about what local government was expected to deliver against a backdrop of increasing central direction in finance and, if it was about ensuring that priorities were determined and needs were met locally, about the ability of local government to take decisions on its expenditure.

4. It is obvious that the provision of local services requires to be financed. Historically local taxation has contributed towards this to some extent. We are concerned to ensure that our recommendations about how the work of local government is financed can cope well with a range of possible scenarios regarding the future delivery of local services.

5. What follows is a brief exposition of the constitutional position and role of local government in Scotland.

CONSTITUTIONAL POSITION

6. There are neither written comprehensive constitutional guidelines nor constitutional conventions concerning local government and its relationship with central government.

7. In November 1995 the Scottish Constitutional Convention recommended that the devolution legislation should commit the Scottish Parliament "… to secure and maintain a strong and effective system of local government, embodying the principle of subsidiarity so as to guarantee the important role of local government in service delivery".[45] However, despite the signing by the UK Government in 1997 of the European Charter of Local Self Government, no such provision is contained in the Scotland Act 1998.

45 Scottish Constitutional Convention, *Scotland's Parliament. Scotland's Right* (1995)

8. Michael Elliot usefully has identified two key propositions concerning the constitutional position of local government.[46] The first is that it is absolutely subject to the will of Parliament and no legislative capacity of local government can take precedence over that will. In Scotland this manifests itself in the form of responsibility by the United Kingdom Parliament at Westminster and the Scottish Parliament at Holyrood for legislation governing local authorities and the services they provide and for statutory instruments made under that legislation. The second is that central government may only exercise coercive power over local authorities by means of legislation. He stated:

> "In common with any other legal persons, both tiers of government have a power to deploy their resources towards any legal end they desire. The centre should only restrict this power of local authorities by express statutory enactment."[47]

9. Midwinter and Mair have identified four key principles whose intrinsic nature has remained constant through the years – *ultra vires*, local discretion, the representative principle and the right to tax.[48] The doctrine of *ultra vires* complements that of Parliamentary sovereignty. Local government is a creature of Parliament and may only act within the powers set by it. Local discretion means that local government can vary its use of statutory powers on the basis of local choice. The nature of that discretion varies among services, from the mandatory to the permissive, but for the most part some degree of discretion exists. Over the centuries this discretion has been steadily eroded as centralisation in the name of ensuring uniformity of services or achieving minimum standards has grown.

10. According to a former Cabinet Secretary, this trend towards centralisation is continuing. Lord Wilson of Dinton recently said in evidence to the House of Commons Public Administration Committee.[49]

> "I think we are in the middle of huge constitutional change. What I have always argued is that there is a trend towards devolution, in formal constitutional terms: devolution to Scotland, Wales and Northern Ireland; and a rebalancing between the state and the individual… At the same time, I think at another level there is a trend towards greater centralisation… The way in which local government has become an agent of central government, which is now declared by government ministers, rather than a democratic local tier of government, is a hugely important development, which has passed by virtually without much debate."

46 Elliot, *The Rule of Law and Central-Local Relations*, ESRC (1981)

47 ibid

48 Midwinter and Mair, *Rates Reform: Issues, Arguments and Evidence* (1987)

49 House of Commons Public Administration Committee, *Fifth Report 2005-06,* Minutes of Oral Evidence (17 November 2005)

11. Many commentators argue that it is the third and fourth principles referred to by Midwinter and Mair – namely direct elections and tax raising powers – that make for local "government" rather than local "administration".[50] Of all the public bodies responsible for the delivery of services, only local authorities are directly elected. This gives them a legitimacy and a mandate that is arguably of a higher order than those other bodies. This status is recognised, for example, through the conferring on councils of a community leadership role. While certain named bodies have a statutory duty to "participate in" community planning,[51] it is local authorities that are to "initiate, maintain and facilitate" the process.[52] We consider the fourth principle (the right to tax) in section 6.

12. The signing of the European Charter of Local Self Government is the most visible indication of the UK Government's view on the constitutional position of local government. The Charter refers to the safeguarding and reinforcement of local government as an important contribution to the construction of a Europe based on the principles of democracy and the decentralisation of power. It asserts that "… this entails the existence of local authorities endowed with democratically constituted decision-making bodies and possessing a wide degree of autonomy with regard to their responsibilities, the ways and means by which those responsibilities are exercised and the resources required for their fulfilment".[53]

13. Our understanding is that the Charter has a very limited status in law at present and that this will continue to be the case unless and until it is enacted into domestic law. Nonetheless, the fact that the UK Government has ratified the Charter, combined with explicit references to the Charter and principles derived from it in subsequent policy statements,[54] would make legislation in direct contravention of the terms of the Charter difficult to defend.

14. Article 4 of the Charter foreshadows the Power of Well-Being given to local authorities by the Local Government in Scotland Act 2003, by providing that local authorities "…shall, within the limit of the law, have full discretion to exercise their initiative with regard to any matter which is not excluded from their competence nor assigned to any other authority."[55] Article 9 deals with the financial resources of local authorities, part of which "…shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.[56] It calls for equalisation to protect financially weaker authorities[57] and local authorities to be consulted on the distribution of resources.[58] These provisions are clearly of great importance to our remit.

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50 See J. McFadden, *Local Government Law in Scotland* (2004)

51 Local Government in Scotland Act 2003, section 16

52 ibid, section 15

53 *European Charter of Local Self Government* (1985)

54 Notably the 1997 White Paper, *Scotland's Parliament*, and the 2001 Partnership Framework document, *The Executive and Local Government Working in Partnership*

55 ibid, Article 4

56 ibid, Article 9.3

57 ibid, Article 9.5

58 ibid, Article 9.6

15. More generally, the establishment of the Scottish Parliament at Holyrood has affected the relationship between local authorities and other organs of government in Scotland. In anticipation of this, and as referred to in section 3, in 1998 the UK Government appointed the independent McIntosh Commission to consider and make recommendations on the future of local government and its relationship with the new Scottish Parliament and Scottish Executive. The Commission, which reported in June 1999,[59] recommended that the Scottish Parliament and the 32 councils should commit themselves to a joint agreement (or "Covenant") setting out the principles underlying the relations between the Scottish Parliament and local government. Under the proposed Covenant both parties agreed to work within the Framework established by the European Charter. A draft Covenant was published in October 2002 but we understand it has not been brought into force.

ROLE OF LOCAL GOVERNMENT

16. There have been numerous attempts to examine the role of local government over the years. Some of these have been made in the context of a discussion of local government finance, including the Layfield Report in 1976. Other reviews have included the Wheatley Report of 1969 which proposed the local government structure which was introduced in 1975, the Widdicombe Report of 1986 on the conduct of local authority business and the McIntosh Report of 1999 referred to already.

17. The Wheatley Report of 1969 was seminal in the history of Scottish local government. Whilst primarily concerned with the structure and functions of local government, Wheatley also argued that local government, with its elective basis and finance raising powers had a constitutional status which should be matched by "genuine local answerability".[60]

18. Layfield argued that local government was valuable in promoting democracy as local authorities were the means by which people could be involved in the making of decisions that affected services and amenities in their own area. Local government allowed for particular public services to be adjusted in accordance with local needs, preferences and priorities, thus enhancing local accountability. Layfield strongly argued that greater administrative efficiency could be achieved by allowing responsibility to be more decentralised.

19. Widdicombe reinforced Layfield's views by arguing that the value of local government stemmed from three attributes – pluralism, participation and responsiveness. Pluralism implied that power should not be concentrated in one organ of state but should be dispersed, thereby providing political checks and balances. Participation was about the quality of democracy within local government and local government offered two kinds of participation: participation in the expression of community views and participation in the actual delivery of services. Responsiveness to local needs was a particularly important attribute, stemming from the elective nature of local authorities.[61]

59 Commission on Local Government and the Scottish Parliament, *Moving Forward Local Government and the Scottish Parliament* (1999)

60 *Report of the Royal Commission on Local Government*, Cmnd 4150 (1969)

61 *Report on the Committee of Inquiry into the Conduct of Local Authority Business*, Cmnd 9747 (1986)

20. The McIntosh Report saw matters from a practical viewpoint. For McIntosh the two essential features of local government were "to serve the people, including, in the case of some of the major statutory services, acting as agents of central government"; and to represent the community, given the status of local authorities as democratically elected bodies.[62] McIntosh felt that, with the onset of the Scottish Parliament, local government would need to look to its democratic credentials. If it did not deliver to Parliament's satisfaction, Parliament would look elsewhere. Local government would therefore have to renew itself continuously.

21. In common with the views expressed in all these major reports, we believe that strong and effective local government is essential if pluralism is to continue to be a feature of our system of governance and if local choice in the delivery of services is to be realised. The recent publication by the Scottish Executive of the discussion document *Transforming Public Services*, which is about the delivery of public services in Scotland[63] should encourage debate about the shape of public services in Scotland.

Stakeholder Views

22. The MORI survey conducted for our report found that the public is most interested in the quality of services that their council delivers and in how efficiently that council spends public money. When asked what factors were most important in determining voting intentions at local elections, quality of services was referred to by 50% of those surveyed and efficiency was mentioned by 46%. These figures compare with 34% for what candidates say or do on policies affecting Scotland or the UK and 33% for the levels of council tax.

23. Responses from the public to our consultation paper did not provide evidence that people are more likely to vote if they pay directly for services. Respondents appear to attach greater importance to who is seen to manage services and to the quality of those services. However, respondents still consider it important that the balance of funding reflects the balance of control over the running of local services.

24. In the GfK NOP deliberative research carried out for us, accountability was seen as the second most important issue after fairness/ability to pay. Most participants wanted their local authority to be accountable on (a) how public money was being spent and (b) where they could go to voice a grievance with local services. They stated that the simplicity and transparency of a tax system were of less concern either ability to pay/fairness or accountability, whilst recognising that the one did impact on the other.

25. Some respondents to our consultation paper raised concerns that accountability has been reduced by a lack of clarity about how council tax is calculated, how proceeds are spent and how local services are paid for. There is scope for some councils to improve the quality of information they provide to local residents.

62 ibid

63 Scottish Executive, *Transforming Public Services* (2006)

26. The MORI Scotland report found that people's preferences were not clear cut so far as regards the "balance of responsibility" between local councils and the Scottish Executive. While a majority favoured local control of refuse collection, roads and lighting, and sports and leisure facilities, views were divided on where the responsibility should lie for schools, police services, fire services and healthcare. MORI concluded that:

> "… it can be said that local authorities tended to be viewed in a more positive light than the Scottish Executive – for example in terms of their priorities for local services and the care with which they spend public money. Moreover, there is a link between people's attitudes towards their local authority and the Executive, and their balance of funding preferences: those who view their local council in a positive light are more in favour of local control of public services. A parallel view exists for the Scottish Executive."[64]

27. These findings are tempered somewhat by a conclusion emerging from the deliberative focus groups undertaken by GfK NOP. They found that local authorities were not seen as being fully accountable on the key issues of how public money is spent and how people can voice a grievance with local services.

TOWARDS A CLEARER ROLE FOR LOCAL GOVERNMENT

28. In a document produced for the Lyons Inquiry, Steve Martin sets out arguments in favour of strong degrees of both local and central control over local services.[65] The advantages of local control over services include:

- Councils are close to citizens and service users and are therefore best placed to tailor services to local needs and preferences;
- Local discretion facilitates engagement by local stakeholders in the design, delivery and monitoring of services, increasing the chances of these services being responsive to the needs and priorities of local service users and taxpayers;
- Local control can enhance local democracy, by making local government more directly and demonstrably accountable to their electorate;
- Councils can work more effectively with other agencies in providing holistic services that lead to improvements in the overall quality of life if they are freed from centrally designed regulations, targets and funding streams.

64 MORI Scotland, *Public Attitudes Towards Local Taxation* (2006)

65 Martin, *The Implications of Local Devolution for Effectiveness and Efficiency in Service Delivery,* Centre for Local and Regional Government Research, Cardiff University (2005)

29. Against this, he lists a number of reasons for a strong degree of central control over how services are funded and delivered. These include:

- Central government is best placed to ensure equity between local areas by checking that all councils achieve certain minimum standards in terms of quality and quantity of service provision;
- Some services can be delivered more effectively and efficiently at regional or national level;
- There is a need for regulation by central government to safeguard the "common good"; and
- Decisions and action by local government might affect the ability of central government to achieve broader economic, social or environmental objectives.

30. In his Interim Report of December 2005,[66] and subsequent paper of May 2006,[67] Sir Michael Lyons placed strong importance on the capacity of local government in England to perform its strategic role effectively and on striking the right balance between achieving national standards and allowing for local discretion.

31. For local authorities local democratic control and accountability is a key concern. Councils want both freedom to govern, subject to electoral endorsement from residents, and to be accountable for their decisions. That to a large extent reflects their wish for a 50:50 balance of funding ratio, and their opposition to ring-fencing, about both of which we say more later. Local authorities argue that there is an ambiguity in current accountability that could best be resolved by giving councils more discretion.

32. In principle, there is a close relationship among four elements of public accountability:

- Political authority to decide how local services are to be provided;
- Political responsibility for ensuring those services are delivered well and efficiently;
- Financial authority to determine a budget; and
- Financial responsibility for using funds efficiently and to best effect in support of political responsibilities.

33. There are correlations among these elements. Whichever layer of government has political or financial authority should be responsible for exercising that authority appropriately. Whichever layer of government is responsible politically for the delivery of services to a certain standard needs either the financial authority to raise the resources necessary to deliver those services or the political authority to prioritise how it uses limited funds in the most effective way.

66 Lyons Inquiry into Local Government, *Consultation Paper & Interim Report* (2005)

67 Lyons Inquiry into Local Government, *National Prosperity, Local Choice and Civic Engagement* (2006)

34. These four elements of public accountability need not always coincide in full. The Scottish Parliament is a case in point. It has full legislative authority across many issues of great importance for the people of Scotland, including education, health, law and order and many aspects of economic development, environmental and social inclusion policy. Yet Holyrood has very limited fiscal authority, with the resources at its disposal being limited to the Scottish Block grant, influence over local taxes and a limited power to vary income tax (through the Scottish Variable Rate). Nevertheless, Holyrood is fully accountable for how it uses the resources at its disposal and the quality and quantity of services that it funds.

Political devolution

35. The division of powers and responsibilities between local and central government is not clear cut. Central influence comes in many different forms – legislation, funding controls, outcome agreements, targets, guidance. Each places a different constraint upon the local authority. Guidance may leave some scope for discretion where a clear legislative provision may not. For example, education authorities are required to maintain school class sizes below a certain number, but have certain discretion over the classroom environment. Also, whilst the school curriculum is prescribed by the Scottish Executive, teaching and learning methods are not. This "central influence" described above both restricts the extent of authority for local government and confuses the picture as to who either is or should be responsible for the quality and quantity of local services.

36. We attempted to find out how much discretion local authorities have over how they spend the income they receive today. We were unable to obtain hard evidence. However, COSLA estimated that almost 80% of local authority budgets is defined by legislation and by the Scottish Executive.[68] In oral evidence, SOLACE estimated that perhaps 75% of expenditure was prescribed by the Scottish Executive and, if expenditure which local authorities cannot avoid in practice were added to these percentages, local authorities might only have discretion over 10% or less of the total revenue budget. These figures raise serious questions over just how much discretion and authority local authorities actually do have in using the funds they receive to tailor and deliver services in accordance with local priorities.

37. The clearest expression of the present relationship between the Scottish Executive and local government is the Partnership Framework signed by the Executive and COSLA.[69] This important document implements the McIntosh recommendation that a formal working agreement should be established between local government and the Executive. The Framework sees the Executive as "… responsible for developing public policy at a national level, for bringing appropriate legislation before the Parliament as necessary, and for the discharge of the functions assigned to Ministers by legislation." Local authorities "…have a democratic mandate to ascertain the needs of their communities and the priorities of their electorates; to plan, coordinate and ensure the delivery of local services accordingly, within the legal framework laid down by Parliament."

68 Letter from Rory Mair, Chief Executive of COSLA, dated 28 February 2006.

69 COSLA & Scottish Executive, *The Partnership Framework: The Executive and Local Government Working in Partnership* (2001)

Financial devolution

38. There is also opacity in the extent of financial devolution that local authorities have. It is clear that local authorities are responsible and accountable for using all funding they receive effectively, efficiently and appropriately. However, although evidence suggests that most of the work of local authorities relates to meeting requirements and objectives set for them by the Scottish Executive, present funding arrangements do not make clear which of the Scottish Executive and local authorities are responsible for ensuring that councils receive sufficient funding to meet these commitments (we return to the issue in the next section).

39. Midwinter painted a picture of what Layfield's recommendations might mean in practice in giving evidence to the Scottish Parliament's former Local Government Committee.[70] He referred specifically to education and said:

> "The Executive has been increasingly concerned to drive education policy and practice, even ring-fencing funding for improvement. There must therefore be a case for the Executive to assume full funding responsibility for the service and therefore full political responsibility also. The benefits of local knowledge could be retained by local authorities providing education on a service level contract basis."

40. He saw this as one side of a coin. The other side was a situation where local authorities should be able to provide a higher share of their funding for other services, for the development of which they hold considerable local discretion. This would reduce the degree of dependency on central government over funding for these services.

CONCLUSIONS

41. The 30 years that have passed since the Layfield Report was published have been notable for the fact that the issues raised by his central recommendations for clarity in the relationship between central and local government, and financial systems that reflect and underpin that relationship, have never been resolved. Despite all the commissions, reports, consultation papers and pronouncements since then, neither central nor local government has been prepared to address the choice posed by Layfield.

42. There has not been a subsequent examination of the fundamental nature of central-local relations. In contrast to the Lyons Inquiry, our remit was not extended to cover the role and functions of local government in Scotland.

70 Scottish Parliament Local Government Committee, *Report of Inquiry into Local Government Finance*, 6th Report (2002)

43. We agree with Layfield, Widdicombe and McIntosh that strong and effective local government is essential if pluralism is to continue to be a feature of our system of governance and local choice in the delivery of services is to be realised. The optimal financial system will be based on a clear definition of the respective powers and responsibilities of the Scottish Executive and local government.

Recommendation 1: It appears to us, from widespread evidence we have received from local government, that there is a corrosive argument about the relationship between central and local government. If this is so, then in order to resolve the argument the Scottish Parliament, the Scottish Executive and the local authorities must grasp this nettle. Unless and until they do so, the underlying problems and consequent less than optimal structures will remain. The Committee cannot emphasise too strongly their recommendation that action must be taken quickly. *Transforming Public Services*[71] is both a welcome and necessary first step but a resolution must be achieved.

71 Scottish Executive, ibid

SECTION 6:
DO LOCAL DOMESTIC TAXES NEED TO BE LOCALLY SET?

INTRODUCTION

1. In the previous section we considered the respective powers and responsibilities that the Scottish Executive and local authorities in Scotland have in prioritising, shaping and delivering services for local communities.

2. In this section, we explore fundamental questions concerning how these services are financed. We explore how appropriate it is that funding for these services should be determined and provided by the Scottish Executive. We also consider whether there is value in the cost of these services being met either in part or in full through taxes set and raised locally.

3. It is clear that the £1.96 billion currently raised each year by council tax on domestic properties must either continue to be levied or be replaced by some other forms of tax. The question is whether those taxes should be set centrally or by local authorities.

THE NEED FOR SCOTTISH EXECUTIVE FUNDING

4. It is clear that some of the funding for local government must come from the Scottish Executive. The principal reasons why there must be an element of Scottish Executive funding for local government are:

- Macro-economic considerations;
- The size of the local tax base and local tax capacity;
- Local variation in service requirements and costs; and
- The unpredictability of tax yields.

Macro-economic considerations

5. Layfield argued in 1976 that "the local government financial structure should reflect the relationship between the government and local authorities".[72] For him central government was seen as responsible for the overall management of the economy. This included:

- The level of output and employment;
- The balance of payments;
- The level of wages and prices;
- The distribution of income and welfare; and
- Ensuring that public expenditure is managed in a way that does not prejudice the Government's economic objectives.

72 Layfield (Chairman), *Local Government Finance: Report of the Committee of Enquiry,* Cmnd 6453 (1976), para 5.1

6. While the environment surrounding the UK economy has changed in the intervening three decades since Layfield reported, the underlying principles remain. About 25% of total government expenditure in the UK is spent by local authorities.[73] It is important that the balance of funding (in terms of who has power to set taxes for local services) is set at a level that does not undermine the ability of the Government of the day to control overall taxation levels and manage the economy effectively.

The size of the local tax base and local tax capacity

7. Central government is funded through a basket of taxes, which are balanced to reflect ability to pay and to meet economic and social objectives. Few local communities have a sufficient tax base to be able to fund the totality of local services which today are provided by local authorities. It may not be possible and it certainly would be very complex and expensive to create an equivalent basket of locally-set taxes at local government level.

8. Some degree of equalisation funding from the Scottish Executive is necessary to take account of differences in the capacity of local authorities to raise tax locally.

Local variation in service requirements and costs

9. Both the cost of providing particular public services, and demand upon those services, vary across the country. For instance, the cost of providing school education will be higher in remote rural areas (where the low population density results in relatively low school sizes) and in areas of deprivation where a relatively high proportion of pupils might have additional support needs, such as free school meals.

10. Equalisation funding from the Scottish Executive takes account of these factors, so the additional costs do not fall on local council tax payers. The aim is to provide broad consistency in service provision but not necessarily identical standards of service (e.g. people living in rural areas cannot expect to have the same degree of proximity to hospitals, schools, libraries and other services as residents of large towns and cities).

Unpredictability of local tax yields

11. In practice, nobody can predict with certainty tax yields in any one year. For local authorities to rely entirely on local taxation would expose the provision of services to risks of tax volatility.

DO WE REQUIRE LOCALLY-SET TAXES AT ALL?

12. In analysing this question, we have considered first and foremost the effect of local taxation on local accountability.

73 HM Treasury, *Public Expenditure Statistical Analyses 2005*, Tables 1.1 & 6.1. It is estimated that in 2005-06 local authorities will have spent £135.6bn out of £518.6bn total managed expenditure.

13. Our consultation revealed quite strong demand (around 90 responses or some 30% of individuals who responded to the Consultation Paper) for a removal of local taxation altogether. This was seen as being achieved through either 100% funding from the Scottish Executive or a nationally set local income tax. However, our public research work revealed less interest or enthusiasm for change.

14. All except two local authorities that expressed an opinion were strongly opposed to 100% funding or the removal of any local tax-setting powers.

15. Inter-dependency of local funding and local accountability have been regarded as received wisdom since Layfield reported. Layfield[74] and McIntosh[75] both concluded that the position of local government was being undermined by increasingly centralised control and lack of financial autonomy and they appeared to assume that local tax-raising powers were a necessary element in local democracy: perhaps a cost of "no representation without taxation".

16. The comparison with The Scottish Parliament is perhaps appropriate. It is recognised as having democratic legitimacy and the Scottish Executive is more than simply a regional administration for Scotland. The Scottish Parliament has limited tax-raising powers and has not used the powers it has. The status of the Scottish Parliament as a legislature and government for Scotland is based on the extent of the powers they have over Scottish life.

17. This inter-dependency appears to have become an unconsciously assumed principle of local government funding that is rarely questioned, let alone challenged. However, we were unable to obtain evidence to justify this tenet, even though we raised the question a number of occasions during oral evidence sessions and we also wrote to COSLA for assistance in understanding their reasons for this position.

18. Those local authorities that oppose 100% Executive funding argue that this would destroy local accountability. For those councils, the ability to give local electorates the choice, either to increase budgets for additional services or to reduce budgets by cutting local tax levels, is critical as a feature which distinguishes local government from local administration. The basis for these views appears to be a belief that there is a direct and inextricable link between the extent of councils' tax-raising powers and their overall powers. Ironically, this view was echoed by some members of the public who expressed support for 100% Executive funding but their opinions appeared to reflect a lack of trust in how local government uses the powers it has.

19. However, Orkney Islands Council and Comhairle nan Eilean Siar saw local funding powers and the question of local accountability as separate. In oral evidence to us, the Comhairle made clear that neither they nor their residents viewed the council as being accountable only for their use of those funds that are raised through council tax:

> "We have to be accountable for every penny we spend no matter where it comes from … We have to respond to our own people and tell them how we are looking after their funds."

74 ibid

75 Commission on Local Government and the Scottish Parliament, *Moving Forward Local Government and the Scottish Parliament* (1999)

20. This view was supported by the Orkney Islands' representatives at the meeting.

21. We asked those local authorities who see tax-raising powers as an essential element of local government for evidence in support of their position. They were unable to provide any objective evidence. As one councillor told us in oral evidence in answering a question as to whether he had any evidence to support the argument that tax-raising powers are an essential element of local accountability: "Well, I believe in God but I have no evidence that He exists either".[76]

22. We appreciate that it is difficult for local authorities to point to precise examples of activities they have been able to fund specifically as a result of setting council tax at a certain level or of how they have been able to afford constraints on council tax increases.

23. We are not persuaded that the existence of local tax-raising powers is an essential element of local accountability. To us, the principal distinction between local government and local administration does not turn solely on the extent or otherwise of tax-raising powers. Accountability depends on how well the services delivered by the local authority meet the community's needs and the power that authority has to prioritise and shape local services, as well as to deliver them.

24. Both Eilean Siar and Orkney told us in oral evidence that they might accept 100% Executive funding, provided the quid pro quo was much greater local discretion over spending decisions.

25. Our scepticism about the tenet that tax-raising powers are essential to ensure accountability is supported by the MORI Scotland survey which, as referred to earlier, showed that the public are more interested in the quality of services that local authorities provide and how efficiently they use public funds than in their use of tax-raising powers.

26. One reason that several local authorities gave for the need for local tax-raising powers is that the funding system otherwise gives councils very little flexibility in which to cope with perceived inadequacies in the funding settlements they receive from the Scottish Executive. If these councils' argument is correct, then the answer is to address the problem, not look for a way to alleviate it.

27. We see no evidence of any link between local tax-raising powers and local accountability from the perspective of local taxpayers. It is not clear that taxpayers recognise the extent to which annual changes in council tax result from local spending choices rather than from Scotland-wide funding and spending decisions such as changes to levels of Executive funding, other adjustments to the broader funding methodology or any additional costs to local government that arise from implementing national policy initiatives.

28. One striking trend relating to council tax rates across Scotland has been a gradual but steady convergence of most authorities' rates towards a national average. In 2002-03, the highest Band D council tax rate (£1,141) was 41% more than the lowest (£810). In 2006-07, the difference has virtually halved to 21% (£1,213 cf £999).

76 Councillor John Morrison, Oral Evidence by the Scottish Liberal Democrats

29. In reaching this view, we have considered the following other factors, namely:

- Parallels with funding for the Scottish Executive;
- Possible conflict with the European Charter of Local Self-Government;
- How 100% Scottish Executive funding might be introduced; and
- Assessment and collection costs.

30. None of these factors persuade us that local tax-raising powers form an essential element of local accountability.

Parallels with funding for the Scottish Executive

31. In oral evidence, we asked several local authorities why they have such difficulties with the concept of 100% central funding, when the Scottish Executive is presently financed in the same way. They tended to respond that local government provides local services or that arrangements for funding the Executive are unsatisfactory and that, in any case, the Scottish Parliament at Holyrood can apply the Scottish Variable Rate (SVR) to adjust the Executive's budget.

32. We recognise there is a growing public debate about the extent of the tax-varying powers of the Scottish Parliament. To quote Lord Steel of Aikwood:

> "The current settlement has improved the ability of Scotland to address its own problems with its own solutions, However it has not solved the problem of a deficit in accountability caused by the UK's highly centralised fiscal system. No self respecting Parliament should expect to exist permanently on 100% handouts determined by another Parliament, nor should it be responsible for massive public expenditure without any responsibility for raising revenue in a manner accountable to its electorate. Greater accountability is not an abstract matter but a principle of good and effective government."[77]

33. Should the case for fiscal reform for the Scottish Parliament become compelling, then we accept that with it might come a stronger argument in favour of tax-raising powers for local authorities.

Possible conflict with the European Charter of Local Self-Government

34. It could be argued that 100% funding would run counter to the European Charter of Local Self-Government which states that "Part at least of the financial resources of local authorities shall derive from local taxes or charges of which, within the limits of statute, they have the power to determine the rate".[78] There is no evidence provided in the Charter to justify the proposition.

77 Steel, *Moving to Federalism – A New Settlement for Scotland*, Scottish Liberal Democrats (2006)

78 European Charter of Local Self Government, Article 9.3 (1985)

35. Our understanding is that the Charter has a very limited status in law at present, and this will continue to be the case unless and until it is enacted into domestic law. Nonetheless, the UK Government has ratified the Charter. This, combined with explicit references to the Charter and principles derived from it in subsequent policy statements,[79] could cause difficulty for legislation which ignores the Charter.

How 100% Scottish Executive-set funding might be introduced

36. We have considered how 100% Scottish Executive funding might be introduced in practice. Using the Scottish Variable Rate (SVR) for this purpose would permanently deprive the Scottish Executive of its availability for other purposes. Furthermore, even if the SVR were used to increase the national basic tax rate by the full 3p, it would only provide around £750 million in 2006-07,[80] or around 40% of total council tax income yield gross of Council Tax Benefit.

37. The Executive could achieve 100% funding by introducing a local tax at a nationally-set rate for Scotland. The local tax could still be collected by councils themselves (as non-domestic rates are now) or by HM Revenue and Customs if the necessary legislative provision was made.

Assessment and collection costs

38. A tax which is assessed and collected locally – as with council tax – but which is set centrally, as with non-domestic rates, might reduce collection costs but any such savings are unlikely to be significant. This factor was referred to by several members of the public who responded to our consultation.

CONCLUSIONS

39. The Committee are satisfied that the Scottish Executive must continue to contribute via central grants towards the cost of providing local services.

40. The Committee have received no evidence that satisfies us as to the need in principle for locally-set taxes and, in particular, that local tax-raising powers are necessary for local accountability.

41. The Committee have been unable to find any evidence in any of our research as to why accountability is enhanced by local government having its own tax-raising powers. Obviously financing local government requires money and later sections deal with the Committee's assessment of the merits and practical feasibility of different tax options. But the argument that local tax raising powers for local government's accountability are "essential", rather than merely "debatable", has not been made.

79 Notably the 1997 White Paper *Scotland's Parliament* and the 2001 Partnership Framework document *The Executive and Local Government Working in Partnership.*

80 HM Treasury, *Tax Ready Reckoner and Tax Reliefs* (2005)

42. One argument put forward for "centralisation" is the increasing public demand for a standard level of services – the avoidance of any "post-code lottery" factor. We recognise there is a need for common minimum standards across the country. But thereafter, the evidence we received from respondents and from local authorities themselves recognised that different communities have different needs. There is a strong view amongst local authorities that they could best meet the needs of their local community if they were given more freedom to manage the delivery of services. We do not think that the "centralisation" trend is either necessary or desirable. The Committee concur with the argument put forward by the local authorities.

43. The Committee unanimously believe in the principle of subsidiarity and are concerned by the creeping erosion of local government's discretionary ability to manage its affairs. Increased "centralisation" has been occurring for decades. We do not believe that this is the most effective way to provide local services.

44. The Committee found compelling the arguments for allowing councils greater or even total power over how they run their affairs. The Committee sees no reason why the principle of devolution should stop at Holyrood. The Committee recommend that the Executive consider exactly how councils could be given control in future over how services are delivered in order to meet the objectives laid down by or agreed with the Executive. Councils should have the power to manage the process of delivery to the objectives rather than be controlled by, say, being given ring-fenced funds.

45. The Committee were attracted by the idea of local tax in whatever form being set centrally with the funds assigned to councils on a "one-line budget" basis – i.e. each council would receive a block grant and then have agreed targets and objectives which they would have to achieve. How they achieved them would be up to each council. Consequently, a council's accountability to their electorate would be focused unambiguously on the delivery of their services.

46. The Committee recognise that such a proposal would be considered radical. However, we believe that the idea is worth further consideration, but only if local authorities were given much greater discretion over their spending decisions.

47. In the meantime, the Committee's recommendations on how to improve local government finance are set out in subsequent sections. We make no recommendation on the retention, reduction or extension of current tax-raising powers for local authorities.

48. We conclude therefore that the answer to the question "Do local domestic taxes need to be locally-set?" and the extent to which they fund local government must be determined in the light of our Recommendation 1 in section 5.

SECTION 7: THE BALANCE OF FUNDING

INTRODUCTION

1. On the assumption that there is a place for local taxation in the local government finance system, a question arises as to what size of contribution a locally-set tax should make to funding for local authorities. In this section we discuss that question. We also consider how important a question this is as part of the overall debate about local taxation in Scotland.

2. At its simplest level, the balance of funding is the balance between Scottish Executive funding towards the revenue budgets that councils have to deliver local services and local funding. This is most frequently expressed as the ratio between:

- a combination of what councils receive from local businesses (Non-Domestic Rates) and the Scottish Executive (Revenue Support Grant and specific grants); and
- the income councils receive from local residents (at present this is the income councils receive as council tax, either directly from local residents or, in respect of those who are in receipt of Council Tax Benefit, from the Department of Work and Pensions).

3. For the purposes of this section, we use this definition of the balance of funding unless otherwise stated. However, this ratio does not take account of all local authority revenues. Fees and charges which councils receive for meeting the costs of various services (e.g. the use of leisure facilities) are excluded, as are rents and other income from housing services.

4. As indicated in section 3, as recently as 1988-89 the balance of funding was almost 50:50 between Scottish Office and local funding. This balance shifted by 1996-97 to 87:13. More recently, the proportion of local funding has increased and, in 2004-05, the balance of funding was 80:20.[81]

5. The balance of funding is generally discussed as a single aggregate figure for Scotland as a whole. This average figure masks some extensive differences between authorities. Local authorities with a lower tax base and/or which face greater levels of need or higher costs to deliver services receive more grant from the Scottish Executive than other areas. The two extremes are City of Edinburgh, with a balance of funding of 75:25, and Comhairle nan Eilean Siar where the balance is 92:8.[82]

6. For the purposes of the following discussion, references to particular balances of funding should be read as Scotland-wide average ratios, which would not necessarily apply in every local authority area.

81 Scottish Executive, *Scottish Local Government Finance Statistics 2004-05* (2006); Scottish Executive, Finance Circular No. 2/2004

82 ibid

PUBLIC UNDERSTANDING ABOUT THE BALANCE OF FUNDING

7. The two pieces of public research conducted for us both tested people's understanding about the balance of funding in Scotland. The results show that, while the public tend to believe that council tax contributes a larger share of local government funding than in fact it does, people do appreciate that councils receive more of their income from other sources.

8. The representative sample survey conducted by MORI Scotland found that people's estimate of the balance of funding was that it was skewed towards local government, with the mean figure for the proportion raised through council tax being 44%. A large number (42%) said they did not know.

9. GfK NOP's deliberative research for our Committee found that participants were able to recall various key sources of local government finance, notably council tax; charges and "fines", and central government grants – with council tax typically being mentioned first. Furthermore, most participants had a reasonable awareness of the balance of funding – most assumed that over 65% of funds for local services came from central government.

10. In contrast, in equivalent work conducted by NOP for the ODPM Balance of Funding Review in England, most people thought that most funding for local services was raised by local authorities.[82] GfK NOP suggests that people in Scotland may feel closer to their local authorities than people in England.

11. It has been argued that strong public awareness of how local services are paid for is an important element of public accountability. In this respect, there remains considerable room for improvement.

STAKEHOLDERS' VIEWS ABOUT THE BALANCE OF FUNDING

12. There is strong support from the local government sector for a change in the balance of funding with many arguing for a 50:50 balance, or something approaching that. This echoes the Scottish Parliament's former Local Government Committee (since replaced by the Local Government and Transport Committee) which in 2002 recommended a change in the balance of funding "to 50:50, or as close to 50:50 as possible".[83]

13. The Scottish Green Party and Scottish Conservative Party argue in favour of local authorities raising a greater proportion of their own income. The Scottish Labour Party support what they describe in their submission as "a balance".

82 Balance of Funding Report, para 1.29

83 Scottish Parliament Local Government Committee, *Report on the Inquiry into Local Government Finance* (2002), para 32

14. However, the general public appears to be less enthused about changes to the balance of funding. The MORI Scotland poll conducted for us found that, once respondents were told of the actual balance of funding, 48% said they were happy with the present situation, while 37% felt that local authorities should have more revenue raising powers. Most participants in the GfK NOP focus groups were happy about the sources of funding. Generally, GfK NOP found that people did not want to see the current balance of funding changed.

15. Our consultation revealed quite strong demand (around 90 responses or some 30% of individuals who responded to the Consultation Paper) for a change in the balance of funding in the opposite direction. This was seen as being achieved through either 100% funding from the Scottish Executive or a nationally set local income tax.

HOW IMPORTANT IS A PARTICULAR BALANCE OF FUNDING?

16. The arguments made to us in evidence about the importance of weighting the balance of funding more in favour of local government can be categorised as follows:

- The relationship between the balance of funding and balance of powers between local and central government;
- The relationship between the balance of funding and levels of public engagement in local affairs;
- Public attitudes towards the balance of funding;
- The "gearing effect";
- The concept of "parity of esteem" between central and local government;
- Scottish Executive's funding levels; and
- Whether or not we can learn anything from practice in other countries.

Relationship between balance of funding and balance of powers

17. It was argued that the balance of funding should reflect the ratio between local government's statutory responsibilities and its discretionary powers.

Relationship between balance of funding and public engagement in local affairs

18. A number of local authorities felt that local accountability would be increased by having a greater proportion of their income that was seen to be raised locally.

19. The Committee sought evidence about whether the balance of funding played a significant role in stimulating public engagement in local affairs. We looked at the level of voter turnout as a test for public engagement. There is some evidence both ways.

20. John Gibson of EFG Research provided the Scottish Parliament's former Local Government Committee with some evidence that people are more likely to vote in local elections when local domestic tax makes up a larger proportion of local government spending.[84] This was based on research on the relationship between the balance of funding and the turnout in local elections in England between 1975 and 1991. However, research for the ODPM Balance of Funding Inquiry found that there was no available evidence demonstrating any direct connection between the balance of funding and election turnout.[85]

21. As discussed in section 5, MORI Scotland reported that respondents to our survey said that, of the factors that were most important in determining voting intentions at local elections, what candidates say or do on issues and policies affecting the local area ranked first (50%); if they are likely to spend public money carefully (46%); what candidates say or do on policies affecting Scotland or the UK (34%) and what candidates say about levels of council tax (33%). Mention of council tax was significantly more likely to be made by those who were dissatisfied with council tax than among those who were satisfied (43%, or 16% of the total respondents).

22. In the Scottish context, the Committee could find no objective research to support the argument that changing the balance of funding to, say, 50:50 would increase local accountability through increased electorate turn-out. As previously mentioned, City of Edinburgh and Comhairle nan Eilean Siar are at opposite ends of the present balance of funding spectrum with the balance being 75:25 in the former and 92:8 in the latter. At the 2003 local elections, the turn-out figures were 51.8% in Edinburgh and 64.1% in Eilean Siar (although it should be noted that both Holyrood and local elections were held on the same day). The latter figure was the highest in Scotland. Edinburgh's turn-out was only marginally higher than the Scottish average of 49.8%.

23. Overall, the evidence from research conducted for our Committee tends to agree with that of the ODPM Balance of Funding Inquiry. GfK NOP reported from the deliberative focus group work that there was no evidence that a shift in the balance of funding weighted to local government either would affect levels of public engagement with local government or that it would have any effect on local accountability.

Public attitudes

24. Whether or not a change in the balance of funding would enhance public engagement in local politics, we received contradictory evidence about the public's broader attitudes to changes in the balance of funding.

25. A strong message came from members of the public who responded to the written consultation that the balance of funding is too skewed towards local taxation. The key reason for this appeared to lie in respondents' dissatisfaction with the fairness of local taxation. Other significant reasons were that a stronger focus towards central government would better reflect the reality of who actually manages local services, and in some cases distrust in the ability of local government to be responsible in their use of tax-raising powers.

84 See Scottish Parliament Local Government Committee, *Report on the Inquiry into Local Government Finance* (2002), para 16

85 i.e. Research report *Balance of Funding and Turnout* by the University of Plymouth and focus group research by NOP World – see paras 1.26 and 1.27 of the Report of the Balance of Funding Review (2004)

26. GfK NOP reported that participants in the deliberative focus groups they undertook generally did not want to see the current balance of funding changed. The principal reasons given related to distrust of council tax; lack of faith in councils to raise and spend money appropriately and efficiently; and concern about the impact on deprived areas in Scotland. Furthermore many felt that central government should regulate and monitor local authorities in their tax-raising function.

Effect on gearing

27. Local authorities argue that a change in the balance of funding is required to deal with the "gearing effect". Gearing in this context is the result of the situation where, when only a small proportion of local government funding comes from local taxes, even modest increases in overall council spending require large percentage rises in local taxes For example, in cases where council tax makes up 20% of council revenue (or £1 in every £5), a 1% growth in total spending with no commensurate increase in central funding requires a 5% increase in the council tax.

28. We received insufficient evidence to assess how important the gearing effect is to the public in Scotland. However, in their 2003 Report, the ODPM Balance of Funding Review group argued that, while the public in England has little interest in the balance of funding itself, they are concerned about rates of increase in council tax that might arise from the gearing effect.[86]

29. For local authorities, the gearing effect exaggerates the public's perceptions about the size of the year-on-year increases in the council tax and leads to the conclusion that councils are responsible for these rises due to their inefficiencies and profligate spending. The argument is particularly important to local authorities because of their claim that the Scottish Executive is not providing the additional funds needed each year to fulfil their current and new responsibilities. A high gearing effect might be seen both by the Executive and by the electorate as being desirable in helping to curb council tax increases and to drive out efficiency savings.

30. Most recently, Sir Michael Lyons has expressed concern that the gearing effect in England "can lead to a distorted focus on the marginal pound rather than the total budget of an authority". However, he was quick to add that changing the balance of funding alone will not, in his view, address the pressures on local services.[87]

86 See Office of the Deputy Prime Minister (ODPM), *Report of the Balance of Funding Review* (2004), para 1.25

87 Lyons Inquiry into Local Government, *Consultation Paper & Interim Report* (2005), para 2.51

31. We believe this is an important point. The key issue is about overall levels of funding and overall spending, not about marginal changes in funding. The gearing effect is not by itself the inevitable consequence of a balance of funding weighted heavily to the Scottish Executive. What the gearing effect does is exacerbate tensions that already exist in the funding system. Whether these tensions are due to inadequate levels of central funding for local services, or whether they reflect a failure on the part of local government to deliver services as efficiently as they might is difficult to decide. There is presently no objective and measurable basis upon which to assess either the sufficiency of Executive funding for local government or the efficiency of councils in delivering services.[88] As a result, the gearing effect creates considerable acrimony in the annual debate between the two sides.

Parity of esteem

32. Several councils highlighted the importance they attach to the "parity of esteem" between central and local government. They highlighted the ability to set a sizeable proportion of their income locally as being a litmus test of this parity of esteem.

33. Other than arguing for "parity of esteem" with central government, no local authority explained why a 50:50 ratio in particular is important. Indeed, some councils argued that the principle of a robust local tax and funding system is more important than the precise ratio.

34. The Committee do not accept that the balance of funding should be an important measure by which the power, influence and beneficial impact of local government is judged. The primary role of local government is to develop and deliver high quality services for local residents and businesses. We believe the more appropriate debate is for local government to demonstrate why it should be given greater authority and freedom to shape and deliver services for their local populations with less intervention from the Scottish Executive. The balance of funding should not be treated as a proxy for the balance of power.

Scottish Executive funding levels

35. In their written evidence, SOLACE argued that greater responsibility should be given to local government to raise funds, because of what they described as "structural faults" in the current funding system.

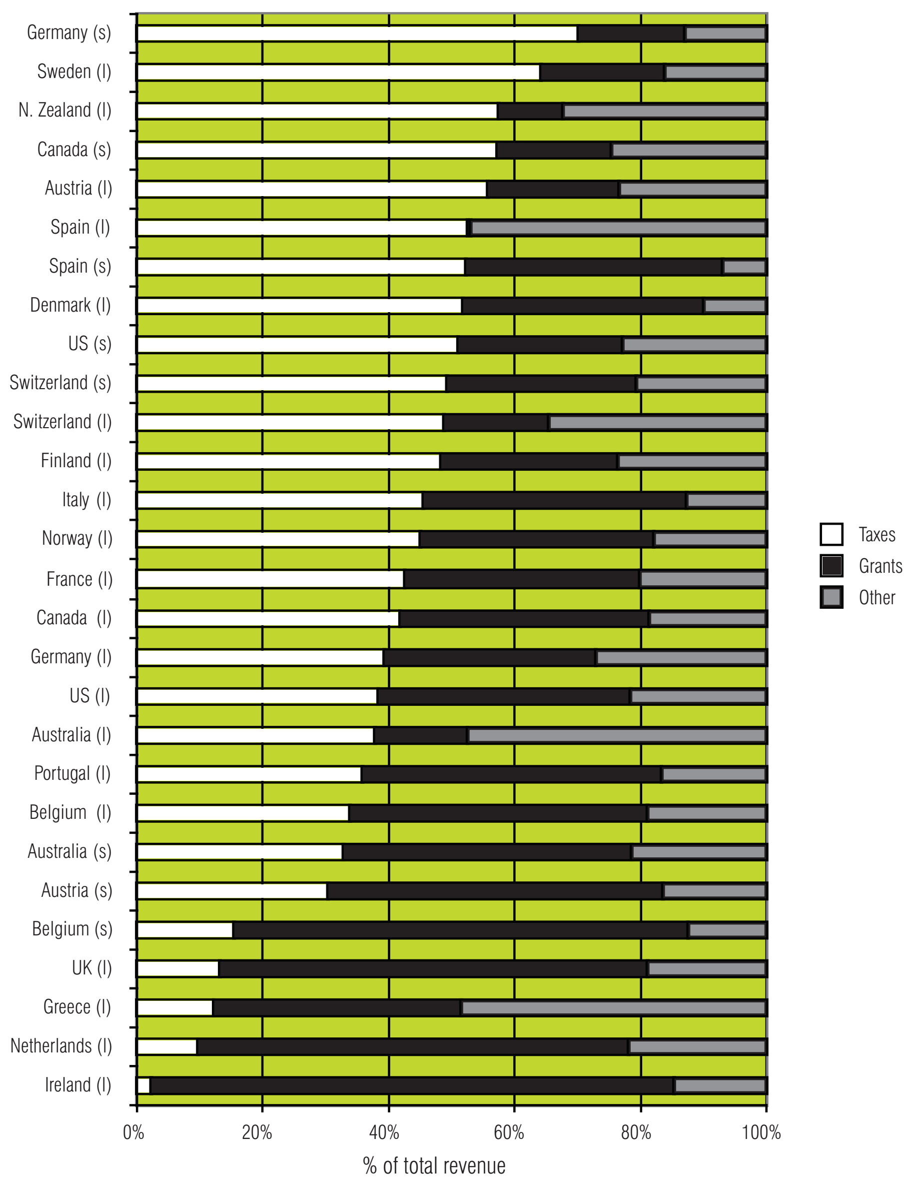
36. The Committee recognises the importance of adequate levels of Scottish Executive funding for local government. However, the significance of adequate funding is so great that any shortcomings require to be resolved in their own right, rather than through changes to the balance of funding.

88 Although it is though worth noting that research conducted for ODPM's Balance of Funding Review concluded that available evidence in England demonstrated only a weak relationship between a highly geared balance of funding and efficiency there (ibid, para 1.28)

Practice in other countries

37. UNISON argued that the balance of funding is too centralised and more centralised than most of the rest of Europe. Certainly the UK appears to have a greater degree of central funding than most other European countries.

Figure 7.1: Taxes, grants and other revenues as a percentage of total subnational revenues[89]



89 International Monetary Fund, *Government Finance Statistics 2006:* Data applies to latest available year, ranging from 2001-04 except for Ireland which relates to 1997.

38. The UK, Eire and the Netherlands fund local government in a broadly similar way, in terms of the split between grant income, local tax revenue and non-tax revenue. As a percentage of total tax revenue, local tax revenue, is very low in the UK. In most other countries, a significantly larger proportion of funding comes from local/sub-national tax revenue, as Figure 7.1 shows. However, some countries with a higher proportion of local tax revenue appear to have even less discretion over how the level of tax is set.

39. Research by John Loughlin of Cardiff University on international comparisons[90] found a general trend towards increasing the proportion of funds that local authorities receive as transfers from central government, with local revenues falling as result. Transfers were increasingly block, rather than ring-fenced, grants. He also found that, in most cases, local authorities had little influence in determining the size or rate of revenue sources, some of which was effectively assigned revenue.

HOW TO CHANGE THE BALANCE OF FUNDING

40. There appear to be three ways through which the balance of funding could be weighted more to local government:

- By removing from local government any funding responsibility in relation to certain services for which the Scottish Executive has lead policy responsibility. These services would be paid for directly by the Executive;
- By allowing local authorities to set non-domestic rates; or
- By increasing the share of local government income that is funded directly by local residents.

Direct funding from Scottish Executive for certain services

41. This option would transfer control of funding from local authorities for those services where councils have little or no scope in practice to determine or influence how the services are delivered. The overall local government budget would fall but, within that total, the amount of money that councils receive from local taxes would stay the same. As a result, the amount of funds that councils received from local taxes would increase as a share of their total budget.

42. For example, education accounts for some 40% of the local government budget at present. If the cost of providing education were funded separately and directly by the Executive, the total local government budget would fall to around 60% of its current levels. If council tax levels remained the same, council tax would provide around one-third of that remaining 60%.

43. A number of suggestions were made as to which services might be most suitable for transfer from local to central government control (see, for example, the suggestion made by Arthur Midwinter for transferring responsibility for education to the Scottish Executive, discussed in section 5).

90 ODPM, ibid, Annex C

44. It may be appropriate for certain services to be funded directly by the Executive. However, it is not for us to advocate such a course of action, particularly as it is not clear, on a service-by-service basis, what the extent of local discretion is. What is clear to us is that such decisions should be taken because they most effectively ensure quality in the delivery of these services, not simply to secure a change in the balance of funding.

Relocalisation of non-domestic rates

45. This was of considerable interest to both local government and those business interests that responded to our public consultation.

46. Many of the local government sector argued for councils to be given the power to set non-domestic rate levels, as well as council tax. Were this to happen, the Scotland-average balance of funding would change from around 80:20 to approximately 60:40.

47. This change would only affect the balance of funding as it relates to the gearing ratio. It would do nothing to change the balance of funding, in terms of the proportion of local government spending that local residents pay through local taxation. The Committee are not convinced that there is a meaningful link between local funding and local accountability but even if there were, there is nothing in this proposal that would enhance local accountability.

48. The pertinent issue is the effect that such a change might have on the future relationship between local government and the business community. Supporters of re-localisation argue that it would foster a better relationship between local authorities and business in their areas. It has been claimed that this relationship was undermined by the decision of the then UK Government in 1989 to nationalise the setting of Scottish poundages as part of the move to a Uniform Business Rate.

49. In the eyes of Scottish business representatives, however, the relationship between local authorities and local businesses has improved, not deteriorated, since 1989 and they have claimed that the reason for this was the nationalisation of non-domestic rates. The Scottish business community also argue that a local tax would be less predictable than nationally-set tax; that there would be little incentive for a council not to increase a locally-set tax; and that councils are not democratically accountable to businesses. For all those reasons, business appears to be strongly against re-localisation of non-domestic rates.

50. The Committee question how many of the arguments about the likely effects of re-localisation on local government's relationship with the business community are intrinsically correct in principle. The arguments' validity appears to depend on <u>how</u> relocalisation was re-introduced. For instance, if a relocalised non-domestic rate was introduced, subject to a cap equal to the rate of any increase in local domestic taxes, this might address the concerns of the business community both about the predictability of a locally-set rate and whether councils could be trusted to keep non-domestic rate increases down.

51. We note from recent reviews in England that a more pragmatic relationship between local government and the business community appears to operate there. In their evidence to the ODPM Balance of Funding Review, CBI expressed support for the idea of allowing some local retention of business rates.[91] Furthermore, in an attempt to reassure business interests, virtually all local authorities and local government organisations argued that the annual increase in NDRs should be linked to the increase in council tax.

52. The question of whether local authorities should have any role in setting business rates also appears to have had a high profile in Sir Michael Lyon's evidence gathering. His Interim Report from December 2005[92] suggested a stronger willingness within the business community to give local authorities a role in tax-setting than their counterparts in Scotland evinced in evidence to us.[93] But there was greater opposition from the CBI in England to the proposal following the publication of Sir Michael's subsequent paper *National Prosperity, Local Choice and Civic Engagement*.[94]

53. Overall, we do not believe the potential economic effects of re-localisation are significant enough of themselves to make a substantial contribution to the debate either in favour of or against re-localisation.

54. One factor concerns how much of any increase in non-domestic rates actually would be paid in net terms by local businesses. There may be a trade-off between rent and other property costs, so that an increase in rates would dampen the ability of landlords to secure large increases in rents. A 1995 article by the Institute for Fiscal Studies[95] states the empirical evidence seems rather mixed overall. In the short term, it seems that businesses tend to bear the bulk of the burden of increased local tax rates. However, in the long run businesses may be able to pass on much of the burden of high local tax rates to their landlords in the form of lower property rents.

55. Arthur Midwinter argued to the Scottish Parliament's Local Government Committee that non-domestic rates should not be re-localised, in order to provide Scottish Parliament with one of the very few sources of income it has power to determine.[96]

56. In oral evidence to us, Councillor Pat Watters, President of COSLA told us he believed that having a uniform business rate is a sensible approach, to provide a clearly level playing field throughout Scotland.

57. We note that Scottish Ministers have announced their intention to bring the Scottish business rate into line with the rate that applies in England, and possibly even below. This could only be achieved if non-domestic rates remained nationally-set.

91 ibid, para 4.16

92 ibid

93 ibid, paras 2.88 to .2.90

94 See, e.g., *Daily Telegraph, Alarm at Return to Local Business Rates* (9 May 2006)

95 Denny, Hall and Smith, *Options for Business Rate Reform*, Institute for Fiscal Studies (1995)

96 Scottish Parliament Local Government Committee, ibid, paras 54-55

Increasing the share of income received from local residents

58. The third way to change the balance of funding would be by increasing the share of the cost of local services that residents pay through local taxes. We do not think that any meaningful link exists between the proportion of the cost of local services that people pay through local taxes and local accountability but this option could be used to test whether or not such a link exists.

59. Not all forms of local tax that are suitable for raising 20% of council income will remain suitable for raising, 40% or 50% of the total. Shortcomings in any tax may have limited impact where the level of that tax is modest but can become unacceptable as the tax level grows. It also becomes more important that a tax does not result in any perverse or unintended behavioural effects that might hinder local economies.

60. One way of reducing the risk of unfairness or unintended consequences is by having more than one type of local tax. A cocktail of local taxes may alleviate any unwanted effects of a disproportionate burden being carried by one tax.

61. A major difficulty with a "cocktail of taxes" approach is that the public might well assume that more types of tax means actually having to pay more tax. Indeed, the GfK NOP report indicated likely public opposition to a hybrid system with more than one form of local taxation, because it could provide an opportunity to increase tax take by stealth. How well this risk was managed would depend on how responsibly a hybrid tax was introduced and on how clearly it could be demonstrated to the public that either national taxes would be reduced as a result or that the additional tax revenue was necessary. A degree of proportionality must be adopted for local taxation. Mirroring the national basket of taxes at a local level might be justifiable in terms of creating fairness, but it would be a complex and costly way of doing so.

CONCLUSIONS

62. We question many of the arguments that have been made in relation to the balance of funding. Change to the balance is often regarded as an important end in itself, with demand for more weighting towards local government being seen as synonymous with local government having greater powers, thus reducing the extent of (in)appropriate central controls upon local authorities. Change to the balance is also considered by some as a more important goal than how it is achieved. For instance, many local authorities argued for non-domestic rates to be re-localised in order to weight the balance of funding more towards local authorities. In many such cases we were surprised that other effects of such a change (such as the effect on councils' relationships with the business community) were considered as being incidental to this primary goal.

63. Our overall conclusion about the importance of the balance of funding is that in itself it is tangential to the main problem. The right level of funding, the relationship between central and local government and the extent of discretion for local government are the crux of the problem.

64. Where there exists a disagreement between the Scottish Executive and local government about either the adequacy of funding for local services or how efficiently councils deliver these services, the gearing effect does exaggerate the extent of difference between the two sides. However, the gearing effect does not create these differences of view between local and central government. Nor would these differences disappear were the balance of funding to change.

65. We have seen no evidence to suggest, nor do we accept the argument, that simply shifting the balance of funding towards local government in itself will improve accountability or the degree of public engagement. Nor do we believe the balance of funding rather than local authorities' ability to develop and deliver high quality local services is the real measure of esteem in the eyes of the public.

66. We have identified three ways in which the balance of funding could be weighted more towards local government. We are satisfied that any of these methods could be used to bring about such a change. However, we do not accept that these methods of themselves offer any justification for a change in the balance of funding.

67. We argue that any change to the balance of funding should be treated as part of the fundamental strategic change we advocate in sections 5 and 6.

SECTION 8:
CRITERIA USED TO ASSESS THE FORMS OF LOCAL TAXATION

INTRODUCTION

1. The remit given by Scottish Ministers requires us to "review the different forms of local taxation… against criteria set by the Executive".

2. The previous three sections discussed two of the criteria listed in our remit – namely "local accountability" and "balance of funding". Those sections set out in detail how we have interpreted these criteria and the weight we attach to each.

3. In this section, we complete our framework of criteria against which we assess the different tax options later in this report. The criteria listed in our remit form the backbone of this framework, although we take time to set out how we have interpreted these. We believe that certain other factors, while not set out in our remit, are also worthy of inclusion in our framework, and these are described later in the section. We explain why we attach different levels of importance to some criteria over others. And we discuss tensions that might potentially apply between different criteria.

A. HIGH IMPORTANCE

SIZE OF TAX BASE

What this criterion is

4. The size of tax base relates to the number of people or households who would be liable to pay the tax. This is one of two criteria we have used to test the accountability of councils to their local residents (the other one is "Identifiability as a Local Tax" – see below).

Why it is of high importance

5. A large tax base is necessary to ensure that the burden of local tax is spread over as many residents with the necessary ability to pay as possible, in order to keep the burden on these residents reasonable.

EFFECTS ON THE ECONOMY

What this criterion is

6. Taxes are not used solely to provide governments with income. The way they are applied, and the levels at which they are set, can affect the choices we make about our working habits, the way we spend money and the property we live in. Taxes are therefore sometimes used to encourage particular behaviour from the public and businesses. The counter-argument is that, when we propose to change or reform a tax system, we must consider how those changes might affect people's behaviour and the broader economy.

Why it is of high importance

7. Any changes that are made to the tax system will not only affect how much income councils can expect to receive from local taxation. They may have a more fundamental effect on businesses, in terms of demand for their products and services and how they develop. They might also seriously affect – for better or worse – the prospects that the public might have about their employment, income and standard of living.

8. It is difficult to anticipate the effects of a particular change in tax on the economy and on people's behaviours. While we can try to predict possible effects in theory, however imperfectly, the extent to which they arise in practice will depend on the extent of change and other factors.

FAIRNESS

What this criterion is

9. While it is clear the public does not hold a single and universally applicable definition of what "fairness" is, there is a clear and very strong association between fairness and the level of people's income and consequent ability to pay tax bills (the Committee's view is expressed below). GfK NOP reported the importance of ability to pay among participants in the deliberative research they undertook for us.[97]

10. Looking at the reasons that respondents to the public survey work conducted by MORI Scotland gave for either being dissatisfied or satisfied with council tax,[98] most reasons were associated with either the level of council tax bills or the fairness of the council tax system. Specifically on fairness, ability to pay was perceived as the most important factor ("Takes no account of earnings/ability to pay" (31%); "Hits pensioners especially hard" (15%); "People in more expensive homes don't pay much more council tax than those in cheaper homes" (15%); "Value of property is reasonable basis for taxation/fairness" (22%); "Relief exists for poor people" (5%)).

11. Beyond this, a correlation also seemed to be evident in the minds of some respondents between fairness and:

- a large tax base where most people have to make some contribution to the cost of local services ("Too many people don't pay, so the rest of us have to pay more" (15%); "Takes no account of the number of people living in a house" (13%); "Good proxy of size of household" (5%)); and
- people's use of services ("Bears no relation to the services people use" (25%); "Good proxy for use of services" (2%)).

97 See section 3.4.1

98 See figures 2 & 3

12. However, the extent of public interest in these factors appears to have been much more limited than in ability to pay. We are separately interested in the size of the tax base for the purposes of promoting public accountability (see above). It therefore seems clear to us that we should consider fairness principally in terms of people's ability to pay local taxes.

13. In this regard, we believe it appropriate to consider ability to pay from two different perspectives. The first is a relative argument that the tax system is progressive and recognises that some households are able to pay higher levels of tax than others.

14. The second is an absolute argument that the tax bill that each household faces is affordable. On this second point, there are links with the criterion "Ease of Assessment, Collection and Payment" (see later).

15. The deliberative focus group work also highlighted a recognition among many members of the public that an individual's ability to pay could be strongly influenced by a range of personal circumstances, as well as income or wealth, and that these should be taken into account.[99] This is a factor that is well recognised within official statistics. The Department of Work and Pensions' Family Resources Survey (FRS) frequently uses the concept of "equivalised income" in its statistics. This involves adjusting results of household income to allow the comparison of living standards between households that vary in size and composition. This adjustment reflects the fact that a family of several people requires a higher income than a single person in order for both households to enjoy a comparable standard of living. The results of our own modelling work also use this equivalised income adjustment in order to assess standards of living within different types of household.

16. Responses to our consultation from members of the public, and feedback from the deliberative focus groups, suggested a strong dislike of a local tax as a charge for "core" services.

17. The public appear inclined to consider the fairness of a local tax system in isolation. This is particularly true of a visible tax, like council tax, which people have to take positive steps to pay. In these circumstances, it is natural for people to consider the fairness through which their liability for that local tax has been calculated.

18. However, local authorities are more likely to draw a link to the role of local taxes as part of the overall tax system. According to this argument, local tax is one element in a basket of taxes which together fund local and national public services, and it is most important that people are taxed fairly in terms of what tax they pay overall. Even if some people appear to be paying more local tax than might be strictly "fair", this may be acceptable provided it is within the context of an overall tax burden that fairly reflects their ability to pay.

19. We agree with this argument to a large extent. We cannot properly assess the burden on household income and on possible economic and behavioural effects of taxation decisions unless we consider how much tax households stand to pay in total from the full basket of taxes.

99 CBI Scotland made a similar point in their submission to us.

20. However, we would qualify this statement in two ways. First, it is important that taxpayers understand how local services are funded. The more accurate their awareness is of how much of the national taxes they pay go towards paying for local services, the more likely they are to accept that meeting the cost of local services depends on more than paying a local tax.

21. Secondly, it is important that the local tax element itself is viewed as at least reasonably fair in itself. For example, it did not appear to matter how small a contribution the former Community Charge made to council funds in the period 1989-93. It still was viewed as being so fundamentally unjust by a significant proportion of the public that many people simply refused to pay and the tax itself became unsustainable.

Why it is of high importance

22. This has been by far the most important criterion amongst the public, as borne out in both of the surveys that our Committee commissioned and in the responses to our consultation. It is also recognised as being an important criterion by local authorities. The importance of this criterion may increase the greater the yield from the local tax. Feedback from Northern Ireland suggests less dissatisfaction about the fairness of domestic rates there, compared with council tax in Great Britain, but average rates bills in Northern Ireland have been notably lower than those in Great Britain.

RELATIONSHIP TO THE BENEFITS SYSTEM

What this criterion is

23. At present, local authorities receive significant funding as Council Tax Benefit in lieu of payments from local taxpayers. In 2004-05, this amounted to £345 million or 17.6% of total council tax income across Scotland.[100]

24. Council Tax Benefit is paid to those eligible for payment and deducted from their council tax bills by local authorities, who administer the scheme on behalf of the Department of Work and Pensions. Responsibility for this Great Britain-wide scheme rests with Westminster, not Holyrood.

25. What is important is how reliant a particular tax model is on a system of benefits underpinning it in order to provide a degree of fairness, particularly to lower income households. For example, Council Tax Benefit is seen as a crucial element of the present council tax system.

Why it is of high importance

26. This was not seen as an important criterion in itself by respondents to our consultation, in that the question of benefit arrangements was not seen as necessary for tax options other than council tax.

100 See Scottish Executive, *Scottish Local Government Finance Statistics 2004-05*, Table 2A

27. However, reliance on the operation of a Great Britain-wide benefits system restricts the freedom of the Scottish Executive to shape and refine a local taxation system in line with its view of Scotland's needs.

EASE OF ASSESSMENT, COLLECTION AND PAYMENT

What this criterion is

28. Our remit asks us to consider the "collectability" of different kinds of tax, how easy or difficult such taxes are to avoid and the question of who would collect these taxes. We have merged these criteria together under this category. So, for each of the major tax models we examine, we evaluate how that option would be assessed, collected and administered (including compliance work). We also consider how easy it would be for local authorities to feel confident that they could obtain all, or close to all, of the possible yield from that tax. A separate criterion below considers the related question of the cost of collecting taxes.

29. However, it is our view that these criteria only reflect councils' perspectives on this important issue. For taxpayers, there is an important issue that is closely connected with ease of collecting taxes, which is about how easy it is for them actually to pay the tax.

30. This issue emerged in the evidence we received.[101] For example, it has been argued that offering taxpayers more flexible payment terms than only 10 instalments per year on their local tax bills can make these bills more affordable for many lower income households. Also important is the speed and ease with which lower income households can claim and retain benefits, where they are a central feature of a local tax system.

Why it is of high importance

31. Given that their expenditure levels are relatively stable, local authorities rely upon a tax that is easy to collect and difficult to avoid. This is one factor that provides them with the security of income they need to plan and provide local services with confidence (alongside, for instance, stability).

32. Often, it is in councils' best interests to make taxes as simple for their residents to pay as possible, to maximise tax receipts. However, we equally believe it is important that rules do not make it more difficult than necessary to pay local taxes. For instance, to offer more flexible payment arrangements may in some cases cause more administrative work for councils. But they should be seriously considered where they can make the cost of paying each instalment of tax more affordable for lower income households.

101 e.g. from Help the Aged, Citizens Advice Scotland

STABILITY AND PREDICTABILITY

What this criterion is

33. Local authorities must be satisfied that they can expect to receive the funding they require to deliver the services they are expected to provide for their local citizens.

34. The issue of stability arises because the proceeds from some kinds of local tax may vary from one year to the next, depending on prevailing economic circumstances. When the yield from a local tax falls, local authorities either need to have assurance that replacement funding will come from an alternative source (such as another local tax or increased AEF) or they may be forced to cut service levels in order to fit the financial constraints they face. As a result, taxes which apply a fixed, regular payment (such as council tax or poll taxes) will tend to be more stable than taxes that are based on the amount of income or spending during the course of a year.

35. Predictable tax revenues help councils to plan their future expenditure on essential services with confidence. In theory at least, even some less stable taxes could be quite predictable, where a time lag exists between a change in circumstances occurring and that change being reflected in the proceeds from a local tax.

36. A potential conflict exists with buoyancy (see below), in that stable taxes will often tend to be less positively buoyant (in terms of offering additional proceeds in times of economic upturn).

Why it is of high importance

37. Stability and predictability are seen by local authorities as being very important, enabling them to plan for service delivery and investment. Since the very purpose of local taxation is to assist local authorities in providing vital and beneficial local services, we recognise the importance of stability to local authorities. Councils should be able to be confident in the income they can expect to receive towards these services.

38. For the public, stability and predictability have not emerged as important issues. However, it is also desirable for taxpayers to have a reasonably clear expectation of how much tax they might have to pay in future. There is an association for taxpayers between predictability and transparency (discussed later).

39. A possible tension arises with fairness for local residents in that taxpayers will also want their tax liability to reflect changes in their ability to pay (especially if their income falls). At a time of economic downturn, when many households might suffer significant decline in their household income, it would be difficult for a tax system to both recognise changes in people's ability to pay and still deliver a stable funding platform for local authorities (unless AEF or the benefits system were comprehensive enough to cover this risk).

TRANSITIONAL ISSUES

What this criterion is

40. We need to consider the nature, complexity and cost of practical preliminary steps that would have to be taken before any reformed or entirely new local taxation system could be introduced and how quickly any new system could be introduced. We also have to consider how best we bring an "old" system to a close and start a "new" system. For instance, should any new system be run in parallel with the current one for a period, and should any transitional arrangements be applied to cushion the impact on individual taxpayers who faced a higher tax liability under any new system.

Why it is of high importance

41. This has not been raised as a major factor by stakeholders. However, we believe this is due in large part to a widespread under-estimation, especially but not exclusively on the part of the public and political parties, as to how quickly change could be introduced. This applies equally to the introduction of a new tax system and to any meaningful reform to the existing council tax system.

42. When, as we believe, any substantial reform could take several years to complete, the trust that people have in the new system could be severely tested by cost, disruption and uncertainty that they might face in the period before it has settled down. This has the potential to create a serious risk to the long-term credibility of a reformed or new tax system, especially in the case of substantial reform if implemented with insufficient planning and preparation.

B. MEDIUM IMPORTANCE

IDENTIFIABILITY AS A LOCAL TAX

What this criterion is

43. This is one of two criteria we have used to test the accountability of councils to their local residents (the other one is "Size of Tax Base" – see above). This criterion relates to how apparent it is to a local resident that the local tax they are paying is being used to contribute to the cost of local services.

Why it is of medium importance

44. We have already made clear that we do not view local taxation as a necessary element of local accountability. Nevertheless, if tax is set and/or collected by a local authority, then it is important that local residents understand the purpose of the tax and, if set locally, how and why a particular rate has been chosen.

COST OF ASSESSMENT AND COLLECTION

What this criterion is

45. Some of the possible local taxation systems will be more costly to collect than others. It is clearly desirable that the costs of collecting a tax should be as low as possible.

Why it is of medium importance

46. This criterion is closely related to "Ease of Assessment, Collection and Payment" (see above), although there is a distinction between the ease of collection and the cost of doing so. Cost was frequently referred to by respondents to our consultation paper (including local authorities and members of the public) as being a relevant consideration.

47. We agree, although a potential tension exists between collection rates and collection costs. We recognise there will be a point at which it no longer becomes appropriate to chase unpaid bills.[102] Local authorities will become reluctant to pursue unpaid local tax when the cost of collection begins to match the anticipated proceeds. However, in some cases it might nevertheless be worthwhile to chase non-payers, even where the cost of doing so exceeds the outstanding sums, to provide an incentive to residents to pay local tax in future. Results from the MORI Scotland survey indicated a sizeable level of public concern about people who do not pay tax.[103] We would therefore argue that even a tax that was cheap to collect might not be appropriate if the tax income proved difficult to collect or easy to avoid.

48. In our later sections covering taxes on income and on property, we consider further what the costs of collection might be. However, it is worth bearing in mind that our fundamental aim is not necessarily to recommend the cheapest possible system for collecting tax. There are two aspects to this.

49. First, a nationally-collected tax scheme (whether it is based on income or on property values) might generally prove less expensive to operate than an otherwise identical system in which local authorities collected their own taxes. But a local scheme may have other advantages (such as making the tax more locally identifiable) which we should also take into account.

50. The second point is that a tax that is cheap to administer might not be very user-friendly from the taxpayer's perspective. We shall not want to rule out features that might make a tax less burdensome for people to pay, simply because it might increase overall collection costs.

102 See oral evidence from COSLA.

103 See figure 2 – 15% of those dissatisfied with Council Tax cited "Too many people don't pay, so the rest of us have to pay more" as a reason (unprompted) for dissatisfaction.

COMPREHENSIBILITY

What this criterion is

51. We have treated this criterion as meaning how easy it is for a person to understand how a tax operates in general terms, rather than how easy it is to calculate liability (which we have covered as "Transparency" – see below). So, for example, most people have a good feel about how VAT is calculated in general terms, even though very few would be able to work out how much they themselves pay in VAT.

Why it is of medium importance

52. We believe that the public are unlikely to trust a tax if they do not understand how it works, at least in basic terms. Provided that basic understanding is in place, we would be minded to concur with the finding from the deliberative focus group work undertaken for us by GfK NOP, that the simplicity and transparency of a tax system is of less concern to most than ability to pay/fairness or accountability, although it might impact on accountability.[104]

TRANSPARENCY

What this criterion is

53. This factor relates to the ease with which a person can calculate how much local tax they are paying.

Why it is of medium importance

54. As a matter of principle, many members of the public would support an argument which stated that taxpayers should be in a position to know how their liability to local taxes year-on-year is changing. This would be particularly important if financial accountability is seen as an important element of local accountability. There is a strong counter-argument, that the visibility of an identifiable tax might affect its collectability.

55. The examples of income tax via PAYE and of VAT show it is possible to have a tax which, in principle, is easy to understand but where the taxpayer is relatively unlikely to know how much tax they are actually paying for local services.

104 See para 3.4.3

C. LOWER IMPORTANCE

BALANCE OF FUNDING

What this criterion is

56. Section 7 set out our views about the Balance of Funding. In practice, the relative importance of different criteria might vary, according to whether the balance of funding is weighted towards central government or local government.

57. For instance, if the local tax element was large, then it would be especially important that a local tax system was considered fair in its own right, that its economic effects would be positive (or at least the negative effects were minimised), and that local authorities could look forward to some stability of income.

58. However, the importance of these factors might not be as high under a system where the local tax only made up a small proportion of overall council revenue (although the public might require some convincing that a local tax that was not obviously fair in its own right could still be acceptable even in these circumstances). Against that, it would become more important in such a situation that a local tax was relatively cheap to collect, so the collection costs were commensurate with the proceeds from the tax.

Why it is of lower importance

59. We have taken as a "given" the current balance of funding. Ultimately, we believe a good local taxation system should exist to support an effective system of local government. We recognise that there is a debate to be held on the role of local government, and the outcome of this will affect decisions about the most appropriate balance of funding. An effective tax system should be able to operate across a range of scenarios, and we shall consider later how effectively different options might work under different balance of funding conditions.

BUOYANCY

What this criterion is

60. This criterion relates to the yield of a local tax system rising under beneficial economic conditions. Such conditions might include growth in income levels or property prices.

Why it is of lower importance

61. Local authorities view buoyancy as important. In particular, they state they would like to be able to take advantage of buoyancy in property values. They argue that this would provide a direct incentive and financial reward for their efforts to stimulate the local economy.

62. The principle of buoyancy has not been highlighted directly by the public as a prominent element in their minds. However, it could be argued that the buoyancy is still an important underlying issue to the public. One of the apparent public dislikes about the council tax, which appears to raise its profile relative to other taxes, is its year-on-year increases. It seems clear that the public is more aware of the council tax rise they face each year than in the increase they will on average face in their income tax payment. This may be because council tax rates have to be announced annually in pounds and pence. In contrast, the public seems to look upon income tax in terms of percentage rates that have stayed constant over a period of years, even though the amounts they are actually paying have been increasing in line with wage inflation.

63. ODPM's Balance of Funding Review report referred to competing arguments.[105] On the one hand, a more buoyant local tax would give local authorities a greater degree of flexibility and allow them to benefit from increased tax revenues delivered by economic growth. On the other hand, the lack of buoyancy reinforces accountability and stimulates efficiency because it ensures that changes in spending levels require changes in council tax rates which are clearly perceived by local taxpayers.

64. We are not convinced by either argument. The latter argument is predicated on the perceived importance of financial accountability, which as already stated is not persuasive to us. As for the perceived benefits of buoyancy, they tend to come at the expense of stability and predictability. Buoyancy can be negative as well as positive, meaning that in times of economic hardship councils might not receive the funding they expect and, as a result of which, local services might suffer. To us, it is more important that councils should be able to plan and budget for the services they provide with confidence, than expose them to the financial risks of buoyancy.

105 See report, paras 2.15-2.16.

SECTION 9: DOMESTIC TAX OPTIONS IN PRINCIPLE

INTRODUCTION

1. Scottish Ministers asked us to consider other possible domestic taxes (i.e. taxes not levied on business) and other options also have been suggested to us. There are a large number of taxes that could be used to support the cost of local services. Essentially, all of them fall within one or more of the following categories:

- Taxes on income (e.g. local income tax);
- Taxes on wealth, including land and property (e.g. domestic rates, land value tax);
- Taxes on people, usually at a flat rate (poll taxes); and
- Taxes on transactions and products (e.g. local sales tax; specific additional taxes on fuel, tourism, chewing gum, alcohol).

2. Some taxes operate as a hybrid of two or more of these types of tax. Indeed, the council tax could be described as a hybrid of 3 different kinds of tax. Council tax is most obviously a tax on property, as the council tax band into which each home in Scotland is placed is based on a value for the dwelling and the land on which it stands. Second, council tax has a large personal tax element to it, which makes it partially a tax on people. Council tax is based on the property occupied by a household that is assumed to contain two adults and properties occupied by only one person are eligible for a 25% discount. Finally, council tax has an income-related element to it, in that Council Tax Benefit provides some protection to households on low incomes (subject to certain conditions, such as savings limits).

3. A summary of the criteria we use in assessing the options before us and the ranking we gave in the previous Section to each of the criterion is shown in the following table. Where we think it relevant to do so, we link certain criteria as shown in the table and consider them together.

Category	High Importance	Medium Importance	Lower Importance
Macro-economic criterion	Effects on the economy		
Fairness-related criteria	Fairness; Relationship to the benefits system	Comprehensibility; Transparency	
Assessment and collection criteria	Ease of assessment, collection and payment	Cost of assessment and collection	
Yield-related criteria	Stability and predictability		Buoyancy
Accountability and balance of funding criteria	Size of tax base	Identifiability as local tax	Balance of funding
Implementation criterion	Transitional issues		

TAXING INCOME

4. Income tax is used as a major source of revenue in most developed countries.

5. OECD[106] figures suggest that the overall tax structure used in the United Kingdom is broadly consistent with the average for OECD countries. In relation to income-based taxes, the UK received 30.2% of its tax income in 2001 from personal income taxes (more than 26.5% for OECD countries as a whole). As referred to below, property taxes are more significant in the UK than other OECD countries. The further 17.0% of UK tax income received from National Insurance contributions, which shares many of the features of personal income tax, was less than the unweighted OECD average, where social contributions made up 25.1% of total tax income. Corporate/profits taxes amounted to 9.5% of total UK tax income, in line with the unweighted OECD average of 9.4%.

6. As far as local government tax revenues are concerned, most other OECD countries either rely predominantly on income/profit taxes (e.g. the Scandinavian nations, Germany, Belgium) or levy them as a major element within a combination of at least three types of tax (e.g. Austria, Japan, Spain).[107]

7. GfK NOP reported that a local income tax was the favoured method of local taxation from most participants in the deliberative focus groups they undertook (although they also reported strong indications that people who might pay more under a local income tax might oppose any change – especially working families). Expressions of support for a local income tax in some form also came from many members of the public who responded to the consultation paper – 96 individuals (33% of total), of whom 42 were clearly pensioners.

8. While the MORI Scotland survey did not seek views on a local income tax itself, it revealed significantly higher levels of satisfaction (37%) and lower levels of dissatisfaction (35%) with income tax than with council tax (21% and 60% respectively.

9. Local income tax is supported by the Scottish Liberal Democrats and Scottish National Party. The Scottish Socialist Party favour a nationally-set Scottish Service Tax, levied on income. The Scottish Labour Party and the Scottish Green Party do not favour a local income tax, while the Scottish Conservatives did not comment.

10. To a large extent, the views of local authorities reflect their particular political make-up. Aberdeenshire and Angus support a local income tax, provided councils can set the level. Perth and Kinross Council also appear to favour this option. However, Labour-run authorities generally oppose it. SRPBA,[108] CBI Scotland and UNISON[109] have also expressed opposition to local income tax.

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106 Organisation for Economic Co-operation & Development (OECD), *Tax Administration in OECD Countries: Comparative Information Series* (2004), Table 16

107 Joumard & Konigsrud, *Fiscal Relations Across Government Levels,* OECD Economic Studies No. 36 (2003), Figure 4

108 The Scottish Rural Property and Business Association

109 A trade union representing people who work in public services

11. In its 2002 report following its Inquiry into Local Government Finance, the Scottish Parliament's then Local Government Committee recommended that the Executive should examine the feasibility of a local income tax in the longer term, in order to supplement and reduce councils' dependence on Executive grants and council tax proceeds.[110]

Macro-economic criterion

12. On the question of possible effects on the economy, obviously this will depend on the level and nature of the tax.

Fairness-related criteria

13. Overwhelmingly, the key reason for public expressions of support for local income tax – both from responses to the consultation paper and the outcome of the GfK NOP research – is the perceived fairness of the association between a local income tax and ability to pay. A particular feature mentioned is the perceived fairness for pensioners, although this also applies to low-income families.

14. However, some low paid people (e.g. students, those living in houses of multiple occupation, those eligible for full/substantial Council Tax Benefit) might be worse off under a local income tax than under council tax. This argument was made by the Scottish Labour Party, among others. CIPFA also warn that interplay with other benefits could mean that, without protection, the very poorest might be worse off with a local income tax than under council tax.

15. However, the perspective of fairness may change when local income tax is considered as part of the basket of taxes. HMRC estimates that income tax generated almost one-third of its tax receipts in 2005-06.[111]

16. If a local income tax that applied only to earned income was introduced, consideration would have to be given to whether or not this would be seen as "fair". We consider this further in section 10.

17. Theoretically, a local income tax running alongside national income tax should not require a stand-alone system of benefits to rebate any part of a liability for local tax. This was reported by GfK NOP as an advantage of local income tax identified by focus groups. However, CIPFA argued that, because of the effects of the benefits system, the very poorest might be worse off with a local income tax than under council tax. The principles of Working Tax Credit and Child Tax Credit show how such assistance could be provided if necessary.

18. The broad principles of income tax appear to be well understood and well accepted by the public. A local income tax, if modelled closely on UK income tax, should therefore prove easy to understand.

110 Para 81

111 HMRC, Tax Receipts and Taxpayers (http://www.hmrc.gov.uk/stats/tax_receipts/table1-2.pdf)

19. GfK NOP's focus groups recognised that local income tax would be less visible than council tax. They broadly seemed comfortable with this, remarking that it would be less controversial, but some fear was expressed that it might become easier for councils to increase the amount of tax people were paying covertly through "stealth" taxation.

Assessment and collection criteria

20. The debate over the collectability of local income tax appears to be influenced by people's particular impressions of the model that would be adopted. There appear to be two options: a tax with a nationally-set rate and a tax with a local council-set rate (as proposed by the Scottish Liberal Democrats and Scottish National Party). Opponents of a local income tax (such as the Scottish Labour Party and several councils) focus upon a locally-variable system, possibly with a different tax rate applied by each authority, which might be very complex and expensive to administer. Aside from the Scottish Socialist Party, nobody suggested a structure of allowances and tax bands for a local income tax that was not based on the UK income tax structure.

21. Supporters of a local income tax see it working in a very similar way to PAYE, with very little need for adjustment. Several members of the public who responded to the consultation paper were attracted by the prospect that local income tax might be collected via PAYE. PAYE was held in high regard by many respondents because it was seen as an effective means of collection from those taxpayers who currently pay income tax through PAYE. In contrast, they tend to perceive the collection rate of council tax as poor, particularly in local authorities where resistance to the Community Charge had been strongest.

22. We discuss in more detail the taxation of all forms of income (both earned and unearned), most but not all of which is paid through the PAYE system, in section 10.

23. A more complex system of income tax could increase the opportunity among some taxpayers to evade payment of the tax.[112]

24. How easy for the taxpayer a tax on income is to pay might be heavily dependant on the particular model adopted. However, the GfK NOP research reported comments from participants that income tax is much easier for them to pay (via PAYE) than is council tax, because it is deducted at source.

25. The cost of operating a local income tax would depend on the model introduced. Assessment and collection costs would fall upon HMRC, DWP and employers in relation to PAYE, and HMRC, DWP and taxpayers in respect of self-assessed income. We consider in greater detail the likely collection costs for certain local income tax models in section 10. In doing so, we bear in mind that a balance might have to be struck between framing a model in a way that minimises costs and at the same time still meets other key objectives.

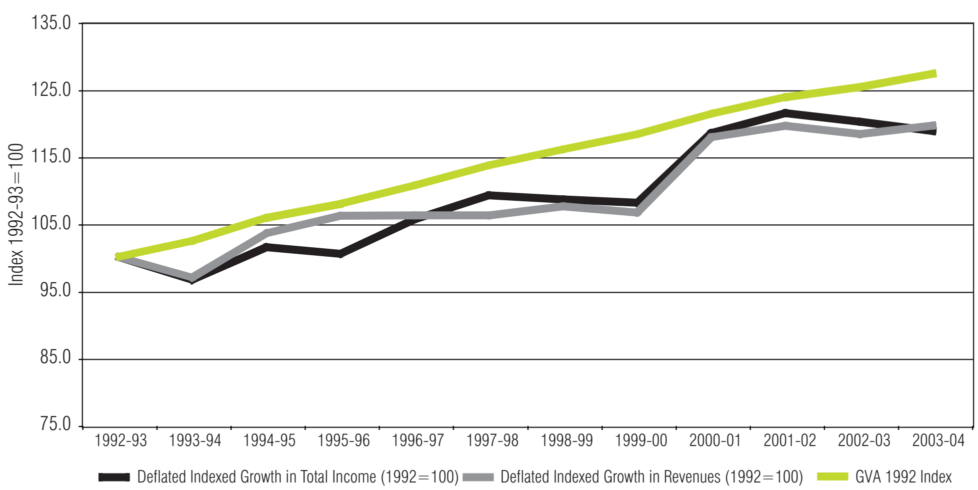
112 Among tax professionals, the terms "tax avoidance" and "tax evasion" are distinct. "Tax avoidance" is the act of using devices allowed under tax law to minimise tax liability. "Tax evasion" involves unlawful means to reduce or escape from tax liability.

Yield-related criteria

26. The Scottish Labour Party and those Labour-run councils that submitted evidence criticised local income tax strongly on the basis that its volatility would undermine its stability and make its yield difficult to predict. The fact that a time lag tends to apply before a decline in the economic cycle affects tax revenue may allow limited scope for anticipated falls in tax income to be foreseen.

27. Available evidence demonstrates that income tax revenues are both buoyant and cyclical, as a result of which they tend to be less stable than a property tax. The most recent slump in incomes and tax revenue occurred in 1993-94. Since then, as Figure 9.1 below shows, income tax revenue has shown modest contractions in some years but little sign of more fundamental volatility. Based on the available evidence, it would be plausible to assume that a local income tax would be cyclical and, in comparison to council tax, relatively buoyant.

Figure 9.1: GDP, income and income tax revenue indices[113]



28. Because of the size of the local tax base, receipts from local income tax would be more volatile than UK income tax receipts. This could be significant for smaller communities.

29. The example of UK income tax shows that, where there exists a stable economic and public expenditure platform, income tax percentage rates can apply unchanged over a period of many years.

Accountability and balance of funding criteria

30. Figure 9.2 sets out the income tax base in Scotland, in terms of the number of income tax payers and their status.

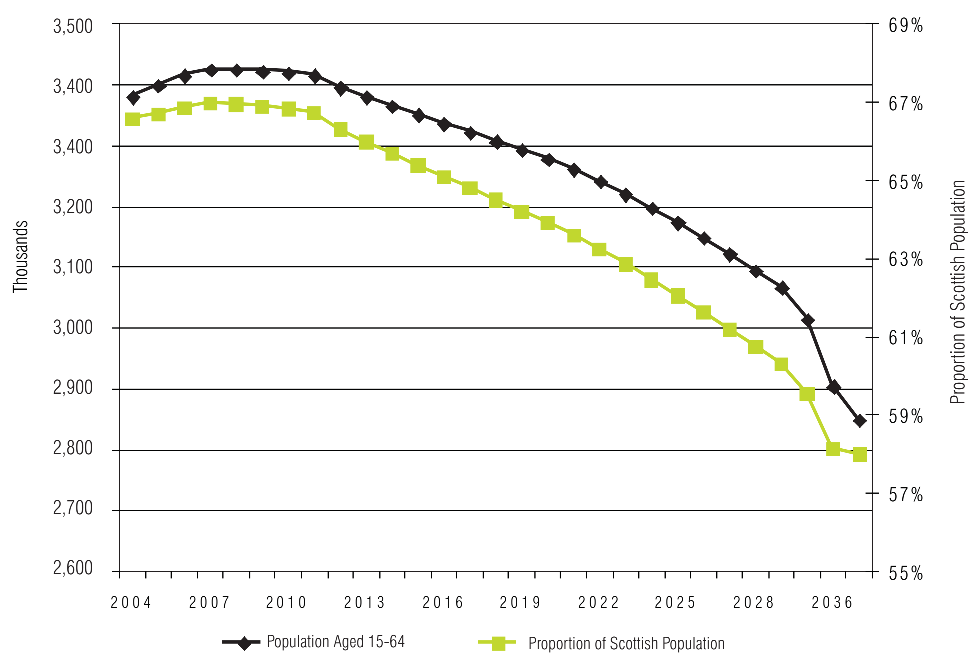
113 HMRC data

Figure 9.2: TAX STATUS OF ADULTS IN SCOTLAND IN 2004-05[114]

	Tax Payer	Non Tax Payer
Full-time employed	1,613,000	12,000*
Part-time employed	348,000	113,000
Self-employed	169,000	22,000
Unemployed	23,000	144,000
Work-related training scheme	0*	13,000*
Retired unoccupied	554,000	912,000
TOTAL	**2,707,000**	**1,216,000**

31. This tax base is likely to change in the years ahead. The size of the working age population in Scotland will fall by 15% – more than half a million – by 2040. Scotland already has a high rate of participation in the labour market trends and past trends do not suggest that immigration is likely to offset this decline in those of working age. It will fall as a share of the total Scottish population from 67% to 58% over the same period (see Figure 9.3).

Figure 9.3: Projected Population Aged 15-64 and as Share of Scottish Population



114 Figures based on HMRC's tax and benefit model (IGOTM) using the Family Resources Survey 2003-04. Figures rounded to the nearest thousand. Particularly small sample sizes are highlighted (*).

32. Future changes to retirement law, working practices and in the costs of pensions may change the convention that those aged between 16 and 64 are of working age. Nevertheless, if council revenue is to be maintained and supported by a local income tax and unless positive buoyancy in income tax receipts throughout this period is assumed, these results suggest that rates will have to be increased to offset the decline in the number of workers.

33. In terms of its perception as a local tax, the Scottish Labour Party suggests that local income tax would not have a visible relationship to local services, in that it would be hidden by UK income tax. We agree with this concern for that tax that was collected via PAYE, where a local income tax might be hidden alongside not only UK income tax payments but also other pay or salary deductions such as National Insurance contributions, pension contributions, trade union levies and charitable deductions.

34. Local authorities and political parties in favour of a local income tax argue that it provides a relatively easy means to weight the balance of funding towards local government, if funding until now collected via national income tax was in future collected via a local income tax. Stephen Smith, in evidence to the Local Government Committee's Inquiry into Local Government Finance, also argued that a local income tax would be capable of raising large amounts of money, unlike most alternatives.[115] This is because taxpayers perceive income tax to have a closer association with ability to pay than other taxes.

35. We note that international comparisons indicate that countries whose local governments raise a large proportion of their own income (such as the Scandinavian nations, the Czech Republic and Slovakia) tend to rely heavily on local income taxes.[116] We also agree that, in principle at least, a local income tax could fit comfortably in a structure where the balance of funding in Scotland was weighted towards local government.

Implementation criterion

36. Detailed discussion on how a local income tax might be introduced is set out in section 10.

Summary

37. It is clear from the public survey work undertaken for us that the most important criterion for a local tax in the minds of most people is that it should be fair and, in particular, that it should take account of a household's ability to pay. The results show that the ability to pay is associated with people's income and therefore a local income tax is the most "fair". However, when probed further, there was little support from those who would have to pay more under a local income tax.

38. UK income tax already accounts for around one-third of UK tax receipts. Adding a local income tax would add further pressure to the existing base of income tax payers, with the potential to hit two-earner households particularly hard. With this could come unwanted economic and behavioural effects.

115 Report, para 71

116 Joumard and Kongrud, ibid

39. A local income tax offers the prospect of buoyancy and it is well understood as a concept by the public.

40. This leaves other criteria, against which a local income tax might score either well or badly, depending on the precise features of the model adopted. It could potentially be difficult and expensive to administer, unstable and unpredictable and that its introduction could be time-consuming and turbulent. In developing detailed models for a local income tax, we have to consider carefully whether these risks could be managed, and if this could be done without tainting the essential perceived fairness of the tax.

TAXING WEALTH (INCLUDING LAND AND PROPERTY)

41. Wealth includes both property and other household assets (e.g. furniture, cars, electrical appliances, jewellery). The possession of wealth, as well as income, improves the owner's quality of life. In theory, the taxation of wealth can cover either the continued ownership of wealth or the transfer of ownership. In this section, when we refer to property we mean real estate, while we refer to other forms of wealth as moveable assets. For the purposes of this report, and given the level of home ownership in Scotland (now 65%[117]), we assume that real estate is an acceptable proxy for overall wealth.

42. It would be possible to tax total net wealth, including moveable assets, after allowing for liabilities. Indeed, several countries do this,[118] but some have been considering its abolition.[119] The tax assessment process appears to be expensive and cumbersome, and there is an incentive for taxpayers to inflate their liabilities (i.e. take out loans in order to invest in tax-favoured or under-assessed assets like property) in order to reduce their liability to the tax. Taxes used in the United Kingdom already used to reflect transfers of ownership of land, property and other assets include stamp duty, inheritance tax and capital gains tax.

43. Property tax is the classic local tax internationally, but is being used less (although Italy has quite recently introduced a new property tax).[120] Australia, Eire and New Zealand principally rely on property taxes as a mechanism for raising tax locally. It is also extensively used in the United States, Netherlands and South Korea.[121]

44. Many of the opinions referred to in this section were expressed in relation to council tax specifically. However, we have used those that appear to be valid in relation to property taxes generally for the purposes of this section.

45. Local taxes are an integral part of the overall basket of taxes in a country and should not be viewed as something entirely separate. The Organisation for Economic Co-operation and Development (OECD) argues that property taxation should form part of the overall tax system:[122]

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117 Scottish Executive, *Scotland's People: Results from the 2005 Scottish Household Survey Annual Report* (2006)

118 Including France, Germany, the Netherlands, Norway, Spain and Sweden.

119 OECD, *Tax and the Economy: A Comparative Assessment of OECD Countries* (2001)

120 Loughlin & Martin, *International Lessons on Balance of Funding Issues,* Cardiff University for the ODPM Balance of Funding Inquiry (2003)

121 Joumard & Kongsrud, *Fiscal Relations Across Government Levels,* OECD Economic Journal No.36 (2003)

122 Joumard, *Tax Systems in European Union Countries*, OECD Economic Studies No.34 (2002)

> "Enhanced taxation of property would contribute to improving the neutrality of the tax system towards various forms of wealth (the main components of which are real estate, financial assets and human capital) and thus serve to rebalance the tax burden away from labour."

46. One of the messages emerging from reviews by OECD of tax systems in certain member countries that features in its Economic Survey series has been about the opportunities that exist in many member countries to increase the taxation of real estate. This includes a recommendation about the benefits of shifting from wealth transaction taxes to taxes on property, to facilitate land developments from which governments can capture rent.[123]

47. The breakdown of tax receipts is shown in figure 4.1. Some 11% of UK tax receipts could be considered to come from taxes on wealth, including council tax (which is treated as if it were purely a tax on property for these purposes) and taxes on the transfer of assets. This is twice the average for OECD countries, although consistent with figures from Japan and the United States.[124] Other than council tax, the principal wealth taxes in the UK are national non-domestic rates (which obviously apply to businesses rather than individual taxpayers), stamp duty and inheritance tax (both of which are taxes on transactions rather than the ownership of wealth).

Macro-economic criterion

48. The inclusion of property taxes within the overall basket of taxes can have a positive effect on the economy. ODPM's Balance of Funding Review Group noted that property taxes are widely used in other countries and reported[125] that a positive feature of council tax is that it is the only non-transactional tax on residential property values. This point was echoed by Stephen Smith in evidence to the Scottish Parliament's former Local Government Committee as part of its Inquiry into Local Government Finance. He said that housing would be largely untaxed, were it not for local property taxation (currently council tax) and added:

> "Encouraging over-consumption of housing by leaving it as one of the few wholly untaxed items of consumption is probably not desirable".[126]

49. Stamp duty and inheritance tax provide taxes on property transactions, which apply where homes and valuable assets change ownership. However, the UK tax system does not target the continued ownership of residential property, other than through council tax.

123 OECD, Tax and the Economy: A Comparative Assessment of OECD Countries (2001)

124 Heady, The Truth About Tax Burdens, OECD Observer (2002)

125 Report, para 3.9

126 Scottish Parliament Official Report, Meeting of 8 January 2002, column 2584

50. Muellbauer and Murphy[127] argue that several factors lay behind the boom and bust in the property market in the late 1980s and early 1990s. Amongst a range of other factors, they suggest that tax changes contributed towards the boom and bust. Analysis by Rosenthal[128] of house-price inflation in the English regions between 1985 and 1990 indicates that local tax reform was responsible for rises in the real cost of housing in this period of 10-17%. These studies (alongside evidence from Meen[129] about the sensitivity of house prices to disposable incomes and Mortgage Interest Relief at Source (MIRAS), which existed at the time) indicate that the presence of property taxation can act as a stabilising influence on property prices.

51. ODPM's Balance of Funding Review Group added that another feature of council tax (and presumably property taxes more broadly) that could be perceived as a benefit is that it encourages efficient use of the housing stock by discouraging people from living in a home that is larger than they need.[130] Some other stakeholders[131] have made a similar point to us, noting the demographic need for additional housing. It could address a number of perceived problems. These include the perceived inefficiency of the use of a large domestic property continuing to be occupied by parents after their children have moved out. Also, property taxes can reduce demand for second homes.

52. Help the Aged in Scotland oppose any such suggestion, in relation to elderly people. Their submission report to our consultation refers to research involving Help the Aged, which argues that:

> "There are important links between an older person's home and their sense of well-being and sense of identity, particularly when they live in a place that has links to their own personal history."[132]

53. This research does not simply state that older people should be encouraged to stay in their long-time home. It also says that factors like security, accessibility and social contact are also important for an older person's quality of life. We address this issue more fully in section 16.

54. We do not doubt the validity of these arguments or the emotional importance of a familiar home to many elderly people. Ultimately, the relative strength of these arguments to combat competing arguments about encouraging the most efficient use of housing stock will depend on several factors that lie outwith our remit – such as the nature of demographic change in Scotland, environment concerns and other issues that constrain the pace of housebuilding in Scotland.

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127 Muellbauer & Murphy, *Booms and Busts in the UK Housing Market,* The Economic Journal (1997, updated 2003)

128 Rosenthal, *House Prices and Local Taxes in the UK*, Fiscal Studies (1999)

129 Meen, *Ten Propositions in UK Housing Econometrics: An Overview of the 1980s and Early 1990s*, Urban Studies (1996)

130 Report, para 3.10

131 e.g. the Scottish Green Party

132 Economic and Social Research Council and Help the Aged, *Quality of Life in Older Age* (2004)

Fairness-related criteria

55. Many respondents to our consultation argued that property taxes are not fair because they do not take account of ability to pay within a household. Households on lower incomes have to pay a greater proportion of their income on a property tax than other households on higher incomes, including households with multiple income earners. The Scottish Liberal Democrats, Scottish National Party and Scottish Socialist Party expressed similar views. Few people said they feel that council tax provides a close link with ability to pay. Nor did they suggest that people have the option of moving to a less valuable home if their existing home is too expensive.

56. Our survey showed that many members of the public do not consider the fairness of property tax in terms of its place in the tax system overall. They appear to look upon local tax as a specific and discrete entity. We received many representations from members of the public, local authorities, political parties and other interests about the extent to which council tax is not a fair tax.

57. Some respondents considered any property tax unjust, as it is a tax on one type of spending, rather than earnings, which penalises people for spending their money wisely (sic) and investing in a home (possibly at considerable sacrifice).

58. To quote Kenneth Gibb,[133] and as supported in more recent commentary:[134]

> "In total, owner occupied housing is very favourably taxed when compared to other investments, other forms of housing provision, and other forms of consumption."

59. Evidence from England,[135] and anecdotal evidence in Scotland, suggest that the availability of good schools or public transport connections can make a difference to the value of otherwise similar properties from one area to another. As a generality, it is reasonable that private benefits from public investments are partially returned in tax to the community. In the case of an increase in the value of a property arising from such community benefits, this is best achieved by a property tax.

60. Local authorities and the Scottish Labour Party describe property values as a good proxy for ability to pay, especially if a supporting benefit scheme (such as Council Tax Benefit) is taken into account. In practice, a benefit system is an important component of a property-based tax.

61. How easy the tax is to understand and to calculate will depend on its particular features.

133 Gibb, *The Council Tax: The Distributional Implications of Returning to a Tax on Property*, Scottish Journal of Political Economy (August 1992)

134 Sawkins & Dickie, *Council Tax in Scotland: The Economic Case for Reform* (2002)

135 e.g. Gibbons & Machin, *Paying for Primary Schools: Admission Constraints, School Popularity or Congestion,* Economic Journal (2006)

Assessment and collection criteria

62. A good local tax should be easy and reasonably inexpensive to collect, to offer a stable and predictable source of funding and to be identifiable as a local tax. A property tax stands up well against these criteria.

63. Property taxes are relatively difficult to evade, as land and buildings cannot be hidden. The Balance of Funding Review group for ODPM stated that a key benefit of council tax is that it is easy to assess and collect.

64. This criterion should reflect how easy a particular tax is for the public to pay, as well as how easily it can be collected.

65. Unlike, for example, income tax under PAYE which is assessed and collected routinely without much action by the domestic taxpayer, property taxes require positive action by the taxpayer in order to pay the tax, even if only to set up and monitor a series of direct debit payments. There is, however, no reason in principle nor in practice why they are awkward to pay, because local authorities can put in place user-friendly payment arrangements without putting their overall collection rates at risk.

66. The likely collection costs of a property tax will depend on its particular features.

Yield-related criteria

67. From the perspective of local authorities as recipients of tax income, property taxes are broadly stable taxes with predictable yield. They require a household to pay a pre-determined amount of tax each year (unlike income and transaction taxes, where the receipts are subject to the vagaries of whatever income or spending levels might be in any given year).

68. In section 8, we concluded that the criterion of stability should be extended to consider stability from the perspective of the taxpayer, in terms of how flexibly a tax can respond to meet any changes in a household's ability to pay the local tax. In this respect, property taxes are very inflexible, as a tax level set for a year on the basis of property value will not change in cases where a household's income suddenly drops during the course of the year. However, an effective benefits system can compensate for such eventualities.

69. Property taxes are not inherently buoyant. Revenue obtained from income and transaction-based taxes increase automatically in line with growth on overall income and spending levels. For property taxes, however, some form of manual adjustment is necessary to achieve buoyancy – either by increasing the rate or level of tax, or by using revaluation to bring in buoyancy.

Accountability and balance of funding criteria

70. In terms of the size of tax base, there are around 2.26 million occupied properties in Scotland on which a property tax could be levied.[137] The presence of a local property tax within the overall basket of taxation widens the overall taxbase, reducing the risk of the total burden of tax falling too heavily on one or two categories of taxpayer.

71. The property tax base has been increasing in recent years, due to changes in the demographic profile of Scotland. The number of households in Scotland is increasing, a trend that is likely to continue, from 2.25 million in 2004 to an estimated 2.46 million in 2017. This is due principally to a reduction in average household size (the mean size of households is expected to fall from 2.22 persons in 2004 to 2.04 persons in 2017[138] as the number of households containing only 1 adult increases).

72. There is nothing inherent in property taxes that make them necessarily either a local or a national tax. However, experiences from council tax and domestic rates over many years show that property taxes are identifiable as a local tax. The rates of these taxes have been set by local authorities and they require the taxpayer to take positive action to pay their tax liability directly to their local authority.

73. Turning to the balance of funding, we believe that, in the UK context, it would not be appropriate for a non-business property tax to make up the majority share of local government's overall funding. It has an important role to play, but within the context of the overall basket of taxes.

74. Among unitary countries, those nations that base local taxation on property taxes tend to be those with the balances of funding weighted towards central government (notably Eire, the Netherlands and the UK).[139]

Implementation criterion

75. The existing council tax system is primarily property-based. There is nothing inherent in a property tax that makes it particularly easy or difficult to introduce. The existing council tax system is property-based and so reforming it or introducing a different kind of council tax should be more straight-forward to introduce than if it were to be replaced by another form of tax.

Summary

76. We consider that a tax on wealth has many merits in principle. In the context of local government finance, we use property as a proxy for wealth.

137 General Register Office for Scotland, *Household Projections for Scotland: 2004-Based* (2006)

138 ibid

139 Joumard and Konigsrud, ibid

77. When looked at as part of the overall tax system, the fairness of property taxes can be justified robustly. Taxing property can be an effective way to broaden the range of taxes within the basket of taxation. Relying too heavily on one kind of tax places a great onus upon those who are liable for that tax. A property tax can provide a valuable means of capturing many people with reasonable means who do not contribute much through other taxes, which reduces the burden upon other taxpayers.

78. Applying a tax to property offers a relevant and valuable means of broadening the range of taxes. A property tax offers potential benefits for the economy, not least in helping to stabilise the housing market

79. The property tax contains attractive features as a local tax. In administrative terms, it can be relatively simple and inexpensive to collect and offers a relatively stable and predictable yield year-on-year. We already have, in the council tax, a system that is largely founded on property values. This means that the process of achieving change should be more straight-forward than under certain other taxation options.

80. In overall terms, an effective and comprehensive system to cope with the problems of low-income households is an essential feature of a property tax, to provide the necessary fairness, based on a household's ability to pay. We examine this issue further in section 15.

81. A property tax is a valuable element within a basket of local and UK taxes. As with any other tax, there is a limit to the contribution it can make to financing local government.

TAXING PEOPLE AT A FLAT RATE

82. The concept of taxing people at a flat rate was the basis for the Community Charge, which operated in Scotland from 1989 to 1993. Similar taxes have been operated in the past in both the United Kingdom and other countries. We understand that such poll taxes, as they are often described, are no longer used as a significant source of revenue by any major countries.[140]

83. The suggestion of a poll tax in our consultation paper attracted many responses. However, the idea was not discussed in much detail by most respondents, not least because the prevailing view was that the very concept of such a tax had been deeply tarnished by the experience of the Community Charge.

84. A substantial majority of respondents strongly opposed a poll tax in principle. However, some individuals favoured the Poll Tax and others expressed support for the inclusion of this option in a hybrid system. This support was based on the argument that all adult residents of a local authority area should make a contribution towards the cost of local government services there. This aspect of the tax was seen as being fair and consistent with principles of local accountability.

85. Amongst local authorities, there was overwhelming opposition to the notion of a poll tax. It was also opposed by ICAS, SRPBA, CBI and UNISON.

140 NERA Economic Consulting, *Options for Reforming Local Government Funding: A Report for the Lyons Inquiry Study Team* (2005)

Macro-economic criterion

86. In terms of its potential effects on the economy, there is evidence to suggest that replacing a tax based on property with a poll tax could result in property values rising, stimulating house-price inflation.[141]

Fairness-related criteria

87. The large majority of comments about poll taxes from responses to our consultation, together with experience of the Community Charge, show that poll taxes are largely seen as being unfair, insofar as they apply at a flat rate and regardless of a taxpayer's ability to pay.

88. Unless a poll tax was set at a very low rate that was affordable to most people, it would be heavily dependent on the benefits system to ensure that some account could be taken of people's ability to pay.

89. The concept of a flat rate payment payable by every individual is very clear. As measures were brought in to take account of different people's varying ability to pay, so would this clarity and simplicity be clouded. A flat rate tax is also simple to calculate.

Assessment and collection criteria

90. A number of respondents considered a poll tax would be difficult to collect. Experience from the Community Charge showed that enforcement then was difficult, as it was a tax on individuals, who are mobile.

91. The cost of collecting a poll tax could potentially be extremely high. Furthermore, the fact that a person's liability bears no direct relationship to his or her ability to pay would mean that either the tax would have to be set at a low level or a complex and extensive benefit system would have to be developed. The costs of either scenario, when compared with the expected proceeds from the tax, would be high. This is on top of any further difficulties that might arise from the collection of taxes from mobile individuals.

Yield-related criteria

92. In theory, the proceeds from a poll tax should be very stable, as changes in population size tend to occur only slowly. As such, the proceeds of a poll tax should be predictable. Practice suggests otherwise, as such predictability could be impaired by the difficulties of collection.

93. Given the relatively stable – albeit slowly declining – size of the adult population, a poll tax would offer negligible buoyancy. Tax levels would have to be uprated annually.

141 Owens and Panella (eds), *Financing Local Government in OECD Countries: The Role of Local Taxes and User Charges in Local Government: An International Perspective,* Chapter 4 by Bird and Slack (1991)

Accountability and balance of funding criteria

94. Theoretically, a poll tax provides a very large tax base, in that every adult would be liable to pay it – potentially around 4.17 million people.[142] To raise the current yield of council tax (gross of revenue received from Council Tax Benefit)[143] and excluding any further exemptions or discounts, a poll tax would require a payment of around £470 per person.

95. One of the main purposes of a poll tax is that it should be clearly identifiable as a local tax. In this respect, poll taxes fit the bill.

96. In terms of how it could adapt to a different balance of funding, it was suggested by some that a poll tax element could at least feature as part of a cocktail of taxes, alongside other elements that better reflected ability to pay. However, the perceived "unfairness" of the tax may ensure that it could only contribute a modest amount of local revenue.

Implementation criterion

97. Even though the present council tax has a personal tax component to it, most people tend to perceive it as a property tax. We believe that introducing a poll tax to a Scotland still burned by the experience of the Community Charge would be extremely difficult. Regardless of how it was developed and framed, such a tax would almost certainly face substantial criticism from the outset as to its fairness and costs of collection, which would almost certainly leave public confidence in it fatally weakened.

Summary

98. We see no justification for considering a poll tax further as a possible replacement for council tax. It may be a simple tax to understand and to associate with local services. If compliance levels were high, it should also be stable and predictable. However, history demonstrates that the absence of a direct link with ability to pay is such a fundamental shortcoming that it would not only be highly unpopular but potentially very difficult to enforce successfully.

99. In practice, we conclude that a poll tax could only survive if set at a very low level and supported by an extensive benefits system. The costs of this and of collecting the tax would almost certainly consume a very large proportion of the tax proceeds.

142 General Register Office for Scotland, *Mid-2005 Population Estimates Scotland* (2006)

143 £1.96 billion in 2004-05 (Scottish Executive, *Scottish Local Government Financial Statistics 2004-05* (2006))

TAXING TRANSACTIONS

100. A tax on transactions could apply as a general sales tax that applies to most or all goods and services as VAT presently does. Alternatively, it could be applied as a selective and incremental tax, on goods such as fuel, tobacco or alcohol. It could also be applied to particular services, such as tourism and hotel beds.

101. International comparison shows that sales taxes are used, although generally in combination with other taxes.[144] In federal countries, such as Australia, Austria, Canada, Germany and the United States, they tend to form a significant share of tax revenues for state government,[145] but considerably less for local government.[146] Amongst unitary countries, sales taxes are not used in Scandinavia[147] or Ireland. They make a small contribution to local tax revenues in France, Italy, Japan, Korea and New Zealand but substantially more in Spain and especially the Netherlands (at around 40%).

102. Bed taxes and other types of tourism tax (e.g. airport departure fees and taxes) are often used in other cities and countries, and are used in particular to assist the promotion and development of tourism locally.[148]

103. The concept of a sales tax attracted a mixed response from members of the public. Some individuals expressed support for this option and others mentioned it as a possible component of a hybrid system. From the MORI Scotland survey, the current national VAT attracted a relatively favourable response from respondents.

104. However, other members of the public expressed criticism. So, too, did the local government sector, although SOLACE[149] suggested that the idea of a local sales tax in place of a portion of RSG may be worthy of further investigation. It was also opposed by SRPBA,[150] SRC[151] and CBI Scotland.[152]

105. Many of the expressions of support for a local sales tax were conditional. Key amongst these conditions were that the rate should be set nationally to avoid encouraging cross-local authority boundary shopping, that basic goods should be exempted from the tax, as with VAT, and that it should only be used to supplement other taxes.

106. The option of a local vehicle fuel tax was very unpopular among respondents. This opposition was echoed in the MORI Scotland survey, where fuel duty attracted the least favourable response of any of the current types of tax listed and 69% of respondents expressed dissatisfaction with it.[153] A local fuel tax was equally unpopular among local authorities.

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144 Joumard & Konigsrud, *Fiscal Relations Across Government Levels,* OECD Economic Studies No. 36 (2003), Figure 4

145 Typically 25-40%, and around 50% for USA.

146 Nil for Australia and less than 10% for Canada and Germany; but 20-30% for Austria and USA.

147 Other than to a very small degree in Norway

148 e.g. Paris (http://en.parisinfo.com/guide_paris/rub5971.html)

149 The Society of Local Authority Chief Executives and Senior Managers

150 The Scottish Rural Property & Business Association

151 The Scottish Retail Consortium

152 The Confederation of British Industry in Scotland

153 See Figure 1

107. Responses to the consultation paper suggest a local tourist tax would be very unpopular among the public. Most comment from local authorities was also critical, although there was some interest in this option from UNISON, West Lothian Council and, particularly, City of Edinburgh Council. In oral evidence, Edinburgh pointed to the possibility of local authorities being given an enabling power to set a local tourism tax if they so wished (including, for instance, for a limited period of the year).

108. Only one tourism industry body – the British Hospitality Association (Scotland) – made a submission in relation to a tourism tax. They strongly opposed the option.

109. The question was raised as to whether a sales tax in addition to VAT would comply with EU law. Legal advice that we received indicates that the answer to the question of whether a local sales tax would breach the Sixth EU VAT Directive[154] would depend to a great extent on the structure of the tax. The more distinctive it appears to VAT then the greater the chance of compatibility.

110. It appears likely that a separate rate of VAT for Scotland or for local authorities would be incompatible with this Directive, as it does not permit differential tax rates within states. However, a tax that applied only to goods (not services), was not multi-stage (as VAT is, for example) and applied only at the point of retail sale to the ultimate customer may be compatible with EU law.

Macro-economic criterion

111. One possible effect on the economy of a locally-set sales tax in Scotland would be a shift in shopping patterns from high-tax to low-tax areas. This is because sales tax income would be paid to the council in which money is spent, even if the person spending lives in another council area. The introduction of a local sales tax or any specific taxes might have an inflationary effect in Scotland.

112. A study by the IFS refers to evidence from the United States, where many local authorities already operate local sales taxes. This suggests that the extent of cross-border shopping is far more severe where a tax is set at city-level than at state level.[155]

113. Much of Scotland's population lives within easy travelling distance of shops in neighbouring local authority areas. Those councils that stood to gain from such a tax would tend to be those with the most attractive and accessible shopping facilities and, potentially, those that could afford to keep their tax rates low. In this case, it appears the incentive for local authorities to keep rates low would be commercial (in order to optimise tax yield from taxpayers across their broader region).

114. The risk of "tax-shopping" might be particularly great for businesses in the South of Scotland, who would face competition from counterparts in the North of England that may not have to apply such a tax. Again, the general principle would appear to apply whereby people are more likely to shop across authority borders where it is relatively easy for them to do so and where the potential savings make this worthwhile.

154 Directive 77/388/EEC

155 Hall and Smith, *Local Sales Taxation: An Assessment of the Feasibility and Likely Effects of Sales Taxation at the Local Level in the UK,* Institute of Fiscal Studies (1995)

115. Given the potential for cross-local authority boundary shopping, there may be reason either to apply a local sales tax at a national rate or to encourage local authorities to set similar tax rates.

116. The growth of internet shopping gives rise to increasing concern insofar as transactions are concerned, because remote and mobile sellers are difficult to tax. Experience from the United States is that many internet sellers do not have to collect sales tax if they have no physical presence in the State. Although the ultimate buyer may be required to pay tax on internet sales, substantial amounts of revenue are lost because the compliance rate is low.[156]

117. We are also conscious of broader economic consequences that could arise from the application of a dual layer of sales taxes at national and local levels, including inflationary pressures, market distortion and interference with macro-fiscal tools.

118. Submissions suggest the introduction of a tourism tax could have a stifling effect on the tourism industry in Scotland. The extent of this effect would depend on the size and nature of any levy that was introduced, and on the uses to which the receipts were put. However, tourism taxes work successfully in other countries.

119. The most frequently raised concern from respondents about a tourism tax relates to its potential effect on Scotland's tourism industry. Support tended to be predicated on the expectation that proceeds would go direct to the local authority in question with no consequences upon their entitlement to AEF. As a result, tourism tax is perceived as a modest supplementary tax for those authorities that could stand to benefit from it.

120. The fact that a tourism tax is perceived as an optional supplementary tax should mean that concerns about impact of the tax on the tourism industry (and also the cost of its collection) could be addressed as part of the decision by each authority in deciding whether or not to introduce it (and if so, how).

Fairness-related criteria

121. There is a clear relationship between transaction taxes and ability to pay. However, such taxes have a regressive nature which undermine their fairness. This is because lower income households are likely to consume more and save less than higher income counterparts. Furthermore, a greater proportion of this spending will be on goods and services that are essential for basic living.

122. Presumably, it is partly to address this regressive element that the UK Government does not apply VAT to "essential" products like many foodstuffs, children's clothes, books and newspapers, while energy is subject to a reduced rate. However, it remains regressive because those people on low incomes, who may be on full Council Tax Benefit or below the starting rate threshold for income tax, would still have to pay tax for any non-exempt purchase that they made. Exemptions from VAT and sales taxes are less effective in addressing fairness because they apply to everyone.

156 NERA Economic Consulting, *Options for Reforming Local Government Funding: A Report for the Lyons Inquiry Study Team* (2005)

123. NERA refer to evidence differentiating between levels of regressiveness in the short-term and long-term.[157] Taking account of "whole-of-life" scenarios, many people will tend to spend all of their income in their youth and old age and then save in their "prime earning" middle years. Nevertheless, sales taxes are regressive for elderly people on low incomes, whose consumption is high relative to their income.

124. Some respondents described a tax on fuel as being unfair, and particularly prejudicial to rural populations, people with limited mobility and those on low incomes who need to drive.

125. We believe a local sales tax could be able to operate independently of the benefits system, if it were used as a supplementary tax or was responsible for collecting a relatively small share of local government revenue. However, we would question its introduction as a full replacement for council tax without measures being set up to counteract its regressive potential.

126. The concept of a local sales tax could be confused with that of VAT. However, a tax based on final retail price is probably easier to understand than VAT, which is applied at every stage of production and development of a product or service. On a transaction-by-transaction basis, a tax based as a percentage of final retail price would be straight-forward to calculate.

Assessment and collection criteria

127. Well-established arrangements already exist for the payment of VAT to HMRC. To this extent, a sturdy possible basis for collecting and ensuring payment of a local sales tax already exists, at least in relation to VAT-registered businesses located in Scotland.

128. Additional compliance arrangements would have to be considered if a local sales tax were to apply to businesses in Scotland that are not VAT-registered. Given the likely difficulties under EU law of introducing a local sales tax in a way that mimicked VAT, the collection system adopted would have to address how the tax payable was both calculated and verified in order to minimise avoidance.

129. Consideration would also have to be given to how such a tax might apply to businesses based outwith Scotland. A drift from local retailers towards internet-based businesses based elsewhere would create difficulties in collecting the tax.

130. From the perspective of the taxpayer, paying a local sales tax should be simple, as it would be automatically charged as part of their transactions.

131. The cost of collecting local sales tax could be high. A local sales tax would have to be introduced on a different basis to that which applies to VAT, as indicated above and new arrangements would have to be introduced for capturing the local sales tax proceeds from all businesses, both those that are currently and those that are not currently VAT-registered.

157 NERA Economic Consulting, ibid

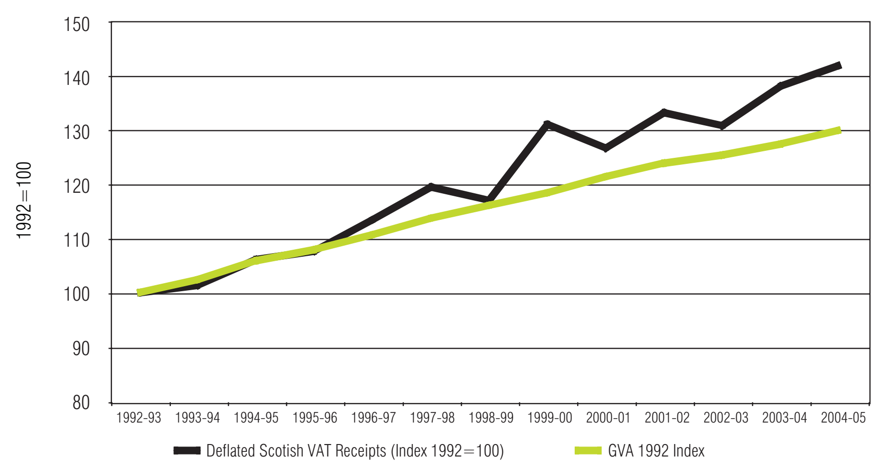
132. Compliance with a local sales tax regime could be expensive for business in Scotland which would have to calculate liability for both VAT and local sales tax. National companies might also encounter difficulties in applying a multitude of different tax rates. NERA reports that, in the United States, around half of all State governments allow retailers to deduct a specified percentage from the sales taxes they pass on to the State, in recognition of their role as 'tax collector'.[158]

Yield-related criteria

133. A local sales tax would be naturally buoyant, with some volatility given its association with income levels and based on the nature of VAT receipts. Therefore, we have concerns about its stability and predictability. Figure 9.4 below provides a proxy for the possible yield of a sales tax. As Figure 9.4 shows, evidence of Scotland's net VAT receipts shows receipts have consistently exceeded GDP growth with some volatility since 1993. The estimates should be treated with extreme caution.[159]

134. From these data, it appears that the real terms revenue generated by a local sales tax would be buoyant, as its index exceeds that of GVA (Gross Value Added), and also cyclical due to a degree of volatility displayed over time. While we cannot infer too much from that in the context of a local sales tax that had a different basis from that which applies to VAT, it offers a degree of comfort about the ability of a sales tax to provide a degree of stability if the broader economy is managed in a controlled and sustained way. Stability could be further enhanced by subjecting essential items, which would be purchased regardless of the state of the economy, to the tax. However, this would clearly be a regressive measure.

Figure 9.4: Scottish percentage share of VAT receipts and GVA[160]



158 ibid

159 These VAT estimates are unpolished data, based on household expenditure and household and population estimates from Office for National Statistics publications. They do not represent the amount of VAT received from businesses registered with Scottish VAT offices or received from businesses trading in Scotland.

160 VAT receipts are calculated as a percentage of the UK total (source for Scottish percentage: Scottish Executive, *Government Expenditure and Revenue in Scotland)*; converted into real terms using the HMT deflator.

135. Any future changes in shopping practices, such as increased internet shopping, could severely affect income raised from the tax. There could be a drift of revenue collected from councils that set higher taxes to those that set lower taxes.

Accountability and balance of funding criteria

136. Sales taxes offer a potentially large tax base. In practice, the application of exemptions on products like many foodstuffs, children's clothes, books and newspapers, that are exempt from VAT, reduces the taxbase.

137. Scotland's share of the United Kingdom's VAT revenue for 2003-04 was estimated to be £5.68 billion (or 8.2% of total UK VAT receipts).[161] That year, council tax income (including Council Tax Benefit) amounted to £1.84 billion,[162] or around 32% of the value of VAT revenue.

138. The tax base of specific taxes is much smaller than for VAT. At a UK level, HM Treasury has estimated it would receive £24.6 billion in fuel duties in 2005-06, compared with £76.3 billion in VAT. If we assume that around 10% (or £2.5 billion) of these fuel duty receipts are attributable to Scotland, the rate of fuel duties would have to increase by 60-70%, everything else remaining equal, in order to replace council tax proceeds.

139. One of the arguments for a tourism tax is that it would extend the tax base, to include overseas visitors to Scotland. Visitors benefit from infrastructure and public services but would not otherwise contribute directly towards the cost of this were it not for a tourism tax.

140. On a transaction-by-transaction basis, local sales tax charges should be clearly identifiable, particularly if taxes were not included in price tickets. Over the course of a year, however, it is likely that few taxpayers would be aware of how much they were paying in total in local tax, especially to their own local authority. It is also our view that, given the opportunities that exist for cross-border shopping, particularly in Central Scotland, there would be little evidence of any association between taxation to residents' own local authority and the provision of local services.

141. Turning to the balance of funding, transaction taxes are typically used in other countries (particularly in unitary countries or at local level in federal countries) as a supplementary tax. Their potentially regressive nature and the risk of adverse economic effects appear to leave them not well suited to financing a large share of local government expenditure.

Implementation criterion

142. A local sales tax could require considerable time to introduce, not least to allow business with the time it would need to prepare for collecting the new tax.

161 Scottish Executive, *Government Expenditure and Revenue in Scotland 2003-04* (2005)

162 Scottish Executive, *Scottish Local Government Financial Statistics 2003-04* (2005)

143. A separate issue arises over how product prices are referred to in national or regional advertisements, when varying local sales tax rates might result in different prices being payable in two different branches of the same chain in neighbouring local authority areas. In the United States, prices shown tend to exclude sales taxes, which allows for account to be taken of local differences in tax rates payable towards the same product or service. However, NERA suggest that it might be difficult for retailers to include references to pricing in national advertising in the EU, as existing consumer laws require retailers to advertise tax-inclusive prices.[163]

Summary

144. It is difficult to make a local sales tax a true local tax in essence, because the proceeds of residents' tax payments would not necessarily go to their own local authority. A sales tax could change people's shopping behaviours, with one possibility being the leaking of the taxbase itself if internet shopping based outwith Scotland were to develop much further, undermining the stability and predictability of the tax in so doing.

145. The fact that a local sales tax could not be administered easily alongside VAT (as the two taxes would probably have to be quite different in form to satisfy EU law) would make the collection of the tax more difficult and expensive than might be expected at first sight.

146. The suggestion of a local motor vehicle fuel duty attracted strong opposition and has little to commend it.

147. We therefore rule out sales taxes and motor vehicle fuel duties as a core feature of a local tax system.

148. There may be more merit to the suggestion of a local tourism tax, but only a modest and supplementary feature of a local taxation system.

CONCLUSIONS

149. Of the options considered in this section, we have concluded that only taxes on property or income justify detailed further examination. These are assessed more fully in the following sections.

150. The only exception might be a local tourism tax which is considered further in section 17.

163 ibid

SECTION 10: A LOCAL INCOME TAX

INTRODUCTION

1. In section 9, we concluded that only taxes on income and property merited detailed further consideration. In this section, we examine a tax on income. As discussed there, we received many expressions of support for a local income tax, particularly from those who assumed that their tax bill would fall compared with council tax.

2. Income tax is tax payable on earnings of employed and self-employed people and includes retirement and occupational pensions. Tax is also payable on unearned income, such as interest on savings and dividends on investments.

3. Three rates of tax currently apply to earned income: starting, basic and higher rates. Three rates (starting, lower and higher) also apply to interest on savings, while two rates (ordinary and higher) apply to investment dividends.

4. Income tax is deducted at source from certain types of income. Employers deduct income tax from the earnings of their employees at source under the Pay As You Earn (PAYE) system, while banks and building societies also deduct income tax at the basic rate from interest on savings at source.

5. Where a taxpayer is liable to pay tax in respect of income received from other sources, for example from self-employment, they complete a Self-Assessment. Tax payable under Self-Assessment typically requires to be paid by 31 January following the tax year in question (tax years run from 6 April to 5 April).

6. A number of previous enquiries have considered the possibility of replacing or supplementing property-based tax with a local income tax. These have included Layfield and the Scottish Parliament's former Local Government Committee. In the past, converting the idea of a local income tax into a practical, viable and workable taxation scheme has proven to be the big challenge.

7. In this section, we examine issues about the design of a local income tax:

- How should a local income tax be assessed and collected (bearing in mind that a local income tax would not necessarily apply only to income subject to PAYE)?
- Should a local income tax have the same system of personal allowances and tax bands that currently applies to UK income tax or a different system?
- What income should be subject to local income tax?
- Should tax rates be set "locally" by each local authority for its own area (as council tax is now) or "nationally" by the Scottish Executive (as the non-domestic rate is now)?

8. These four issues are examined in turn.

9. We then assess how a local income tax might operate in practice, under the following categories:

- Local income tax rates;
- Administering a local income tax;
- Estimating the costs of a local income tax; and
- Other issues.

10. For the purposes of this report, we have assumed that a local income tax would be introduced only in Scotland. This assumption has a number of consequences, which are discussed later.

How could a local income tax be assessed and collected?

11. The administration of income tax has two key elements: assessment (or calculation) of tax liability, and collection of the tax. A local income tax could be assessed and collected either:

- In parallel with the UK income tax system; that is, by employers and HMRC in the case of income subject to the PAYE system, and by taxpayers and HMRC in the case of those taxpayers subject to Self-Assessment.
- By local authorities; or
- Through a universal system of Self-Assessment.

12. The most practical basis for collecting a local income tax would be through HMRC. For people in employment, this would result in the tax being collected by employers and remitted to HMRC through the PAYE system. Earners in self-employment would pay tax to HMRC under Self-Assessment.

13. Unlike those other countries (such as the USA) where all individuals complete a tax return, the UK income tax structure is designed to maximise the collection of tax at source and minimise the number of individuals who have to complete Self-Assessment returns.

14. Amongst the public (both participants in the focus groups conducted by GfK NOP and members of the public who responded to our consultation), there was a desire or an assumption that a local income tax should be integrated with the PAYE system, which people appear to trust. There appeared to be very much less enthusiasm for a local income tax administered either by local authorities as council tax currently is or through universal self-assessment.

15. A tax collected separately by local authorities would be more easily identifiable as a local tax than one collected by HMRC, given that local income tax payments could be less identifiable within payslips.

16. Nevertheless, we take the view that the system would be complex and expensive if responsibility for collection were to rest with local authorities. The capacity of local authorities to administer a local income tax was described well in a paper produced by CIPFA for the ODPM Balance of Funding Review.[164] They remarked that, although local authorities have well developed revenue collection capabilities, these are not linked to income assessment processes (other than in administering Council Tax Benefit). There would be negative economies of scale were each council to operate their own administration operation. There would also be a need for a considerable training programme, accompanied by a recruitment drive for scarce resources experienced in tax administration.

17. We assess other issues relating to the administration of a local income tax later in this section.

NEED A LOCAL INCOME TAX REFLECT THE UK INCOME TAX STRUCTURE?

18. We have considered whether a local income tax should necessarily be restricted to the tax structure that presently applies to UK income tax. For example, should a local income tax be subject to the same band thresholds and personal allowances as UK income tax?

19. With the exception of the Scottish Socialist Party (SSP), no respondent suggested that a local income tax should depart from the UK income tax structure of allowances and tax bands. The SSP proposed a Scottish Service Tax that would have applied a distinct structure of tax bands. Their proposal was designed to achieve a redistribution of wealth within Scotland and the proponents of the Bill considered that a different tax band structure was an important means of achieving this. Beyond ensuring that a local tax applies in a way deemed to be fair to households of differing incomes and wealth, it is not part of our remit to consider the use of the local tax system as a means of achieving a redistribution of wealth.

20. There appears to be no compelling reason why different tax bands should apply across Scotland. The complexity and cost for employers and for HMRC in administering a series of local income tax arrangements, each with their own series of bands, would be immense.

21. UK income tax bands are settled, well understood and broadly accepted. Applying the same bands to both UK and local income taxes would ensure that the local income tax system was relatively easy to understand.

WHAT INCOME SHOULD BE SUBJECT TO A LOCAL INCOME TAX?

22. Given that support for a local income tax appears to be based on its perceived greater "fairness", it follows that fairness requires the tax to be levied on all income, so that people whose income comes from one source should not be at a disadvantage to those whose income comes from another source or sources. However, to include different types of income within the scope of a local income tax makes it more complex and expensive in terms of its assessment and the costs of collection.

164 *BoF(19): Reviewing the Case for a Local Income Tax* (2004)

23. A local income tax should cover all income to maximise the tax base, so that the desired overall tax yield is obtained by the lowest possible marginal tax rate.

24. As Figure 10.1 below shows, UK income tax payments in 2006-07 are estimated to total £131 billion. Since approximately 7.3% of UK income tax is attributable to Scotland,[165] we estimate that £9.58 billion of income tax payments will be attributable to Scotland in 2006-07.

Figure 10.1: Projected UK income tax payments 2006-07[166]

Type of income	Projected income tax (before deduction of tax allowances) (£m)		% of total income tax	
Earned income	119,870		91.4%	
– *Starting rate*		*(5,770)*		*(4.4%)*
– *Basic rate*		*(74,200)*		*(56.6%)*
– *Higher Rate*		*(39,900)*		*(30.4%)*
Savings income	4,130		3.1%	
Dividend income	7,210		5.5%	
TOTAL	**131,210**		**100.0%**	

25. Figure 10.2 shows the projected number of taxpayers in Scotland. It also subdivides them, according to the marginal tax rate at which their next £1 of earnings would be taxed. The "savers" rate category includes taxpayers whose next £1 would be taxed at either the lower rate for savings income or the ordinary rate for dividends. The higher rate category includes taxpayers whose next £1 would be taxed at higher rate, and includes all earned income, savings and dividends at that rate.

Figure 10.2: Projected number of taxpayers in Scotland 2006-07[167]

Type of taxpayer	Number of taxpayers (000s)	% of total
Starting rate taxpayers	295	11.5
"Savers" rate taxpayers	66	2.6
Basic rate taxpayers	1,970	77.0
Higher rate taxpayers	231	9.0
Total taxpayers	**2,560**	**100.0%**

165 Scottish Executive, *Government Expenditure and Revenue in Scotland 2003-2004,* 2005

166 HMRC, *National Statistics Review*, Table 2.6, Updated April 2006

167 HMRC, *National Statistics Review*, Table 2.2, Updated April 2006

Earned income at starting rate

26. There is no reason in principle why a local income tax should not apply to earned income at starting rate. However, in terms of yield, the effect of including earned income at starting rate would be modest: £13 is raised in UK income tax from earned income at basic rate for every £1 that is raised from earned income at starting rate.

27. If a local income tax was being considered for earned income at starting rate, careful consideration would have to be given to its overall effect on low income households. Depending on where respective rates were set, it is possible that some households could actually find their net income decline as their earnings increased, once increased UK and local income tax and national insurance contributions had been deducted and reduced benefit payments were taken into account.

Earned income at basic rate

28. Earned income at basic rate provides the core of income tax revenue (56.6% of UK income tax liabilities, and probably a higher proportion of liabilities attributable to Scotland). We have assumed that any practicable proposal for a local income tax would include earned income at basic rate.

29. A local income tax administered by employers and HMRC limited to earned income at basic rate would be the most straight-forward version to introduce.

The Scottish Variable Rate as a proxy for a local income tax

30. The Scottish Parliament already holds a limited power to vary UK income tax (the SVR). While the SVR is not itself a local income tax, we have briefly considered whether it could be used as a proxy for one.

31. The SVR only applies to earned income at basic rate; tax at this rate can be varied (up or down) by up to 3 pence in the pound. Even if raised by the full 3 pence, SVR would only raise around 40% of the taxable income currently collected through council tax (an estimated £810 million in 2004-05[168], compared with council tax income that year of £1.960 billion[169]). Use of the SVR in this way would deprive the Scottish Parliament of the opportunity to use it in any other way.

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168 HM Treasury, *Tax Ready Reckoner & Tax Reliefs* (2003)

169 Scottish Executive, *Scottish Local Government Statistics 2004-05* (2006); figure is gross of Council Tax Benefit

32. The fact that the SVR applies only to earned income at basic rate reflects the model set out both in the Scotland White Paper[170] and the 1995 proposals of the Scottish Constitutional Convention.[171] Heald and Geaughan[172] reported contemporary criticism surrounding the absence of a tax liability at higher rate which, it was claimed, would result in higher rate taxpayers paying a lower proportion of their income under the SVR than many basic rate taxpayers. Heald and Geaughan also set out why the Scottish Constitutional Convention and then government might have decided to propose the tax-varying power in this way. They argued that it was appropriate to focus on people's total tax contributions, rather than what was paid under any one type of tax. They also pointed to a risk of potential economic disadvantage for the finance and other industries in Scotland.

33. We recognise that there are two key differences between the SVR and a local income tax. First, the SVR is a discretionary power: the Scottish Parliament can decide whether or not to use and has a practical choice to vary the level of any SVR it applies in line with policy objectives of the day, subject to the maximum variation permitted by the Scotland Act 1998 of ±3%. In contrast, local taxation is a core and long-term element of the overall basket of taxes. Second, as discussed above, even the maximum potential yield from the SVR is significantly less than the revenues that are currently collected from non-business local taxes.

Earned income at higher rate

34. Perceived fairness requires the inclusion of income taxable at the higher rate within the scope of a local income tax. Earned income at the higher rate provides around 30% of UK income tax liabilities, although it is likely its contribution towards those liabilities attributable to Scotland would be less than this.

Income on savings and investments

35. A particular issue arises in relation to income on savings and investments, which together account for 8.6% of projected UK income tax liabilities for 2006-07 (although less in Scotland[173]).

36. Different types of tax collection arrangement would need to be introduced to deduct a local income tax element from different kinds of investment income. In relation to savings interest, financial institutions currently deduct a 20% flat rate for all taxpayers, while a tax credit of 10% is currently deducted from company dividends, which eliminates any basic rate liability. In both cases, higher rate taxpayers pay additional liability via Self-Assessment returns. Collection arrangements for a local income tax on interest on savings and investment income would have to match income to individuals (which could be difficult, e.g. in relation to nominee and joint accounts). Any development which increased the need for Self-Assessment procedures would operate counter to established Government policy, which is to provide for as much tax as possible to be deducted at source.

170 The Scottish Office, *Scotland's Parliament* (Cm 3658) (1997)

171 Scottish Constitutional Convention, *Scotland's Parliament: Scotland's Right* (1995)

172 Heald and Geaughan, *The Tartan Tax: Devolved Variation in Income Tax Rates,* British Tax Review (1997, No.5)

173 HMRC, *Personal Income by Tax Year 2003-04*, Table 3.13 (2006)

37. In their evidence to the ODPM Balance of Funding Review, CIPFA concluded that:

> "taxing investment income raises many problems, none of which appear to be capable of being satisfactorily resolved within reasonable cost".[174]

38. The UK Government considered in 1997 whether the SVR should apply to this income. They concluded that "savings and dividend income should in future remain exempt from any income tax variation power, in order to ensure that such income is taxed on a consistent basis throughout the UK, thus avoiding economic distortion."[175]

39. We consider later in this section the possible costs of applying a local income tax. Available evidence suggests that a tax on unearned income could prove very expensive to operate, relative to the tax receipts it could produce.

40. In line with the conclusion of CIPFA and evidence that was given to the Scottish Parliament's former Local Government Committee on this point,[176] the only practicable option is that a local income tax should be applied only to earned income. However, this conflicts with the principle of fairness.

WHO SHOULD SET LOCAL INCOME TAX RATES?

41. A question for a local income tax concerns how tax rates should be set: whether local authorities should have discretion to set tax rates to cover their own residents, or whether the Scottish Executive should set a standard rate of tax that applied throughout the country.

42. A local income tax would be more readily identifiable as a local tax if the rate was set by the local authority than if a standard rate was applied across Scotland as a whole. Both the Scottish Liberal Democrats and the Scottish National Party envisage it to be a locally-set tax. So too do the local authorities that expressed to us their support for a local income tax (the Scottish Socialist Party envisaged their proposed Scottish Service Tax would be set centrally). Overall, however, this preference for a locally-set tax appears to be predicated on the belief that it is an essential feature of local accountability.

43. As discussed in section 7 above, the ability to raise taxes locally has not been a particularly important element of local accountability as perceived by local residents. We further question how visible any local income tax might be if much of it was collected via PAYE, where it might be hidden within payslips alongside other elements such as UK income tax, National Insurance and pension contributions and charitable deductions.

174 *BoF(19)* (2004)

175 The Scottish Office, *Scotland's Parliament,* Cm 3658 (1997)

176 Evidence by Professor Stephen Smith, *Inquiry into Local Government Finance,* para 72 (2002)

44. A separate issue relates to the effect on the broader economy of a local tax-raising power. Applying a higher rate of local income tax could result in certain behavioural changes among taxpayers. These are discussed in greater detail below. At this point, it is worth noting that the effect of these changes may be different, depending on whether a local income tax was applied at a single rate across Scotland or at different rates in each local authority area.

45. The other significant factor relates to the relative costs of operating a locally-set or nationally-set variant of a local income tax. A local income tax set by local authorities and potentially offering the prospect of 32 different tax rates would be significantly more complex and expensive to administer. Management systems used by HMRC and employers might need considerable development to cope with these complexities, which include problems associated with tracking residency. We consider these extensively later in this section.

LOCAL INCOME TAX RATES

46. We have assumed that any replacement tax should raise the same amount as local authorities receive in council tax, including from households in receipt of Council Tax Benefit. In their modelling work for our review, the University of Stirling calculated an approximate Scotland-average local income tax that might be payable in 2006-07 under a range of scenarios. They estimated that the tax rate would be around:

- 7.9% if applied only to earned income subject to income tax at basic rate;
- 6.5% if applied to earned income subject to income tax at basic and higher rates; and
- 5.7% if applied to all income (earned and unearned). If an amount equivalent to the Council Tax Benefit paid in Scotland were paid to local authorities as an additional grant, then the estimated rate of a local income tax which applied to all earned and unearned income would be approximately 4.5%.

47. The modelling work could not provide robust evidence on the differential effects of a local income tax according to the circumstances of particular households. The range of variables that would affect tax liability – e.g. council tax band, local authority area, whether a single person's discount applies, the number of working adults and the taxable income of each – is so great that it is extremely difficult to say definitively which households would benefit from the replacement of council tax by a local income tax. The burden could fall most heavily upon families with more than one working adult. For example, a household with two adults each earning £20,000 and currently paying an average £1,129 council tax for an average Band D home would instead pay around:

- £2,020 local income tax, if the tax applied only to earned income at basic rate (the 7.9% rate); or
- £1,670 local income tax, if the tax applied to earned income at basic and higher rates (the 6.5% rate); or
- £1,710 local income tax, if the tax applied to all income, including earned income at starting rate (the 5.7% rate).

48. As stated in section 9, the demographic complexion of Scotland is changing, with the number of people of working age projected to decline by 15% – more than half a million – by 2040. Such a trend might affect the size of the tax base and, consequently, the rate that would be payable under a local income tax.

49. The potential narrowing of the tax base creates the risk of placing a further burden of funding upon existing income tax payers. The results would be resistance, including a disincentive to work or efforts to avoid payment from among those who are liable to pay income tax.

ADMINISTERING A LOCAL INCOME TAX

50. Many of the respondents to our consultation who expressed support for a local income tax referred to the convenience of PAYE as a mechanism for collecting. They placed an assumed trust in the PAYE system to be able to cope smoothly with a local income tax bolted onto existing income tax arrangements.

51. In practice, how straight-forward a local income tax was to administer would to a large extent depend on the precise features of the model introduced. Nevertheless, it is apparent to us that preparing for and operating such a tax would place significant new demands upon employers and HM Revenue and Customs. For taxpayers, the introduction of a local income tax may require changes in how they pay their tax.

52. In the following paragraphs we consider issues concerning the administration of a local income tax in practice. In doing so we have drawn largely from an assessment of the practical implications of different models of local income tax, produced by a former Deputy Chairman of the Board of the Inland Revenue in 1992,[177] as well as a more recent examination by CIPFA.[178]

53. We have not asked HMRC to provide us with a detailed evaluation of how certain models might operate in practice and the associated costs of administration. We have benefited from informal discussions with HMRC on a number of points and are grateful for the assistance they have been able to provide. However, the views in this section are the Committee's own.

54. It is worth noting a feature of how the UK income tax system deals with employment income. Many countries operate an approach to deduction of taxes during the year which relies on taxpayers completing a tax return at the end of the tax year, as a result of which they either pay any tax due or claim a refund of tax overpaid.

55. The UK PAYE system is designed to collect the right amount of tax from week to week, and month to month throughout the tax year. As a result, the individual should end the year with no tax owing and no tax repayment to claim. It is a system that seems to appeal to taxpayers, most of whom are not required to deal directly with HMRC. Around 9 million of the total 31 million taxpayers in the UK are currently required to complete Self-Assessment returns.[179]

177 Isaac, *Local Income Tax: A Study of the Options* (1992)

178 ibid, *BoF(19)* and *BoF(25)*

179 House of Commons Public Accounts Committee, *Filing of Income Tax Self Assessment Returns,* 23rd Report of Session 2005-06 (2006)

56. However, the workability of PAYE arrangements depends on HMRC and employers being able to apply the right reliefs and allowances and deduct the right amount of tax at each given point of the year. It is a system that relies on a series of tax codes that reflects these reliefs and allowances.

57. In the following paragraphs we explore administrative issues in more detail, under the following categories:

- Predicting yield;
- The tax assessment and collection cycle;
- Residency issues;
- Precision of tax rate; and
- Role of employers in administering a locally-set tax.

58. This discussion is not designed to provide an exhaustive assessment of the types of administrative issue that would have to be resolved. There would inevitably be a substantial volume of matters of important detail. A technical consultation paper produced by the Inland Revenue in 1998 about the operation of the SVR illustrates the extent and nature of some of the issues that would have to be considered in relation to a local income tax.[180]

Predicting yield

59. Local taxes are used to meet the spending needs of local authorities. A local authority cannot budget for a deficit for day-to-day spending purposes. As a result, councils need to be able to predict the yield of a local tax in any given year with a degree of certainty.

60. In the case of a local income tax, the actual yield could either exceed or fall short of expectations, depending on the number of taxpayers living in a local authority area and their levels of taxable income which would be affected by local economic circumstances. This would require authorities, as part of their budgeting process, to make the best assessment they could each year of those two factors. It might be necessary to consider a role for the Scottish Executive in topping up shortfalls in yield in lean years, although this in turn might necessitate detailed involvement by the Executive in scrutinising councils' initial predictions of local income tax yield.

61. Local authorities' budgeting processes could potentially be easier if they were supplied (either directly by residents or by HMRC) with information about the likely income of their residents in the year ahead. However, we think that supplying local authorities with what at the moment is confidential information about incomes would be unacceptable to the public. In any event, many taxpayers would find it difficult to predict their future income accurately.

180 Inland Revenue, *Annex to Press Release 18/98* (February 1998)

The tax assessment and collection cycle

62. At present, households are notified in February or March of their council tax bills for the financial year commencing on 1 April.

63. A slightly longer timetable applies to the annual updating of income tax codes under the PAYE system. HMRC determines tax codes in January or February and notifies employers of these before the start of the new financial year. These tax codes can then be adjusted as necessary to take account of the Budget in March. Employers then apply these tax codes to take effect in the pay period following mid-May.

64. If a local income tax is to be deducted from earned income through the PAYE system at the same time as UK income tax is collected, sufficient time would have to be given for local income tax rates to be confirmed and notified to employers. This would be a particular issue in the case of a locally-set tax, if local authorities had to decide upon their tax codes and then notify HMRC, which would collate a potentially large number of different tax codes for dissemination in turn to employers.

65. Overcoming this pressure would probably require one or more of the following measures to be taken:

- local authorities bringing forward their budget timetables (with implications in turn for the timing of announcements by the Executive of the local government finance settlement for the following year);
- obligations upon local authorities to produce and manage a balanced budget being relaxed;
- tax collection arrangements taking account of a potential delay in tax codes being confirmed. These adjustments might include applying provisional tax codes at the start of the year with in-year adjustment once tax codes had been confirmed, delaying commencement of collection of local income tax until these tax codes had been confirmed, and making end-year adjustments of tax liabilities.

66. Particular issues relate to the self-employed. In 2003-04, around 13% of earned income in the UK and 11% of earned income in Scotland was self-employment income, with 3.5 million UK taxpayers and 243,000 Scottish taxpayers earning income from self-employment.[181]

67. Under Self-Assessment, tax liabilities for self-employed earners are calculated on the taxable profits arising in the current tax year. If the accounting period for the business is different from the tax year, then tax is calculated on the profit arising in the 12-month accounting period ending in the tax year. Taxpayers are required to complete a Self-Assessment return for the year in question by the following January. Two payments on account, based on tax payable in the previous tax year, are normally made prior to the submission of the Self-Assessment return. In light of this return, the taxpayer either receives a refund of any overpayment made in the payments on account or has to pay any additional tax due.

181 HMRC, *Personal Income by Tax Year 2003-04,* Tables 3.6 & 3.13 (2006); for comparison, the total number of taxpayers receiving employment income = 22.0 million in the UK and 2.0 million in Scotland.

68. The impact on a local income tax is that it is not possible to collect all non-PAYE revenues in the tax year to which they relate. This raises potential cash flow issues for local authorities, especially in the first year of operation of a local income tax.

Residency issues

69. A decision would have to be taken as to whether a local income tax should be payable according to a person's place of residence or where they work. Place of residence is probably simpler to define (not least for temporary and peripatetic workers). It equates with the present local council tax system and it provides a link between a taxpayer and services provided for their household in the area where they live. Among those respondents to the consultation who referred to the issue, place of residence was also the preferred basis for assessment.

70. However, the current UK income tax system is not organised on the basis of where a taxpayer lives. The information that HMRC holds about people who pay tax only through PAYE is the information that employers are required to provide to HMRC. HMRC systems recognise Scottish postcodes for the purpose of determining whether the address is either in or outwith Scotland. Employers are not currently required to tell HMRC when their staff move home.

71. The administration of a locally-set local income tax could require the compilation, updating and enforcement of a register of taxpayers for each local authority area. In evidence to the Scottish Parliament's Local Government Committee, Stephen Smith suggested that "with a local income tax, there would be more places with different rates than if there were simply a single different income tax rate in Scotland, so there would have to be more micro-level enforcement of residence declarations".[182]

72. Employers and HMRC would have to track the movements of these residents in order to know what rate of local income tax they would be liable to pay. In the case of a nationally-set tax, the point at issue would be whether or not the taxpayer lived in Scotland. Under a locally-set local income tax, it would be necessary to identify the local authority area in which the taxpayer lived. Experience from the community charge which was attached to a potentially mobile individual rather than a fixed property indicates that a large number of people move home each year, often to a different local authority area.

73. A range of additional refinement to tax codes would be required to distinguish the council area within which each taxpayer lives. In order to associate a correct tax code to each taxpayer, HMRC would have to identify and maintain records of each taxpayer's home address. This, in turn would place a new obligation upon taxpayers and/or their employers to notify HMRC when their address changed.

74. We understand that HMRC has already been giving thought to this issue in considering how the SVR might operate. Postcode would be the identifier for assessing which taxpayers resided in Scotland and so were affected by the SVR. However, people may have various postcodes (including c/o addresses) if they have more than one residence, so a reconciliation exercise would be required to ensure that each tax record had the correct postcode allocated to it.

182 Scottish Parliament Local Government Committee, *Official Report – Meeting No.1*, 2002 (2002)

75. This reconciliation task would be significantly more complex for HMRC in the case of a locally-set local income tax. SVR requires taxpayers to be distinguished between those who are resident in Scotland and those who are not. This locally-set local income tax model would oblige HMRC to do this and also correctly identify which of the 32 local authority areas each taxpayer resides within.

76. This alternative scenario would place a substantial obligation upon employers to assess local income tax liabilities for their employees, by requiring them to apply a series of tax tables varied according to the particular tax rate applied by each local authority in which their staff reside.

77. Other complicating factors arise. One is how to treat taxpayers who move home during a financial year, either in or out of Scotland or (in the case of a locally-set tax) between two council areas in Scotland. The choice lies between basing residence for the whole year on the basis of where a person lived on a particular date (e.g. 31 March each year), or apportioning liability more precisely according to the amount of time in which the taxpayer lived at each residence during the year. AJG Isaac noted that most countries apply the former option.[183] The choice is one of simplicity or precision. So that the correct tax code was applied to any particular year, it might be necessary for residence on a particular date to relate to a date in the preceding financial year. Equally, if liability was apportioned in accordance with where the person lived during a particular year, an end-year adjustment of tax liability might be required to make any necessary corrections.

78. Another factor relates to the treatment of those taxpayers who do not have a fixed address and also those who have more than one home. Arrangements and working assumptions would have to be set in place to deal with both types of situation.

Precision of tax rate

79. Local authorities set council tax rates each year at a level that will meet an anticipated funding need quite precisely. Income tax operates on a different scale. As AJG Isaac said: “Income tax yields big money”.[184]

80. This creates a potential tension as to how precisely local authorities should be permitted to set a local income tax under a locally-set system. Simply increasing a local income tax rate from 6.5% to 6.6% would be akin to raising council tax by 1.5%. Permitting local authorities to vary the income tax rate by smaller fractions might enable them to target the rate more precisely to the desired yield (subject to the fact that the unpredictable nature of income tax at a local authority level and especially in the case of authorities with a small population would make it harder to forecast yield accurately than under a council tax). However, it would also make the tax regime more complex and require employers and HMRC to handle a potentially large number of different tax rates.

183 ibid
184 ibid

Role of employers in administering a locally-set tax

81. The Institute of Chartered Accountants of Scotland (ICAS) expressed concern about the administrative costs, including on business, and cross-border difficulties for UK-wide companies, if a locally-set tax were introduced. ICAS had fewer concerns about a nationally-set tax. In their oral evidence, the Confederation of British Industry in Scotland (CBI Scotland) expressed concern about the possible effects on business of a local income tax. They too were concerned particularly about a locally-set tax.

82. CIPFA explained that there would be potential difficulties for employers in administering a local income tax, in light of consultation with the CBI and the Institute of Payroll and Pensions Management (IPPM).[185] The extent of this additional burden would depend on the number of tax rates involved and the nature of the employer. For example, a higher burden might apply to employers with staff living in all council areas, in cities to where staff might congregate from a number of authority areas, those with high staff turnover or a large proportion of casual, short-term or seasonal workers, and smaller firms running manual payrolls.

83. CIPFA reported that the capacity of current IT system to deal with a number of different local income tax rates would be a major issue. They referred to CBI as being of the view that current IT capacity may only be able to deal with 3 or 4 rates.

ESTIMATING THE COSTS OF A LOCAL INCOME TAX

84. We have assessed the possible costs of introducing a local income tax. The estimates assume that:

- a local income tax replaces council tax;
- tax liability would be based on place of residence rather than place of work; and
- a local income tax would not be applied to earned income subject to the starting UK tax rate. No account has been taken of any additional costs of applying a local income tax to that income.

85. Costs of setting up and running a local income tax system would vary depending both on what taxable income was subjected to local income tax and on whether the tax rate was set nationally or locally.

86. As a general rule, we anticipate that the Scottish Executive would be expected to compensate HMRC and the Department of Work and Pensions (DWP) for any costs they incur in setting up and operating a local income tax scheme that applied to Scotland only. Businesses would be expected to bear any costs they incurred themselves without compensation from the Executive.

185 BoF(25)

87. We consider cost issues in turn under the following headings:

- savings from the abolition of the council tax;
- costs of a local income tax which applied only to earned income subject to the basic UK tax rate and which was nationally set;
- costs of a local income tax which applied only to earned income subject to the basic UK tax rate and which was locally set;
- costs of a local income tax which applied to earned income subject to both the basic and higher UK tax rates and which was (a) nationally set or (b) locally set; and
- additional costs of applying a local income tax to income from savings and dividends as well as earned income.

Savings from abolition of the council tax

88. The abolition of the council tax would produce savings for both Assessors, who would no longer have to maintain the Council Tax Valuation List, and local authorities, who would no longer have to collect the tax. However, local authorities would still have to collect non-domestic rates and administer the Housing Benefit Scheme.

89. The Scottish Assessors' Association told us that, if Assessors were no longer required to maintain the Council Tax Valuation List, the reduction in their workload might produce savings of around £6.5 million per annum to their current annual budget of £37 million. Even if council tax were abolished, Assessors would remain responsible for maintaining the Valuation Roll of non-domestic properties and, except in one council area, electoral registration.

90. In addition, there would be a savings of around £35.6 million per annum as a result of local authorities no longer having to collect the council tax. So in aggregate, the abolition of the council tax could produce savings of around £42 million per annum.

Costs of a local income tax which applied only to earned income subject to the basic UK tax rate and which was nationally set

91. This option mirrors the SVR, the set-up and running costs of which were estimated in the 1997 Devolution White Paper. Updating the figures, we estimate that the costs of this option would be as follows.

92. Set-up costs. These would be around £12 million for HMRC, £7 million for DWP (both of which might require to be compensated for by the Scottish Executive) and £55-60 million for employers (although these costs could be phased). HMRC have already taken steps to prepare for the possibility that the Scottish Parliament might want to use the SVR power. As a result, the additional costs which HMRC would incur in implementing this local income tax option should be modest, as the basis for calculating the tax should already be built into the systems of HMRC. Employers would have to incur the above noted additional costs.

93. Running costs. HMRC, DWP and employers would incur running costs. We estimate that these costs might be similar to those estimated for the use of the SVR itself. When the Scotland Bill was introduced to Parliament in December 1997, these costs were estimated at £8 million per annum for what is now HMRC, £1 million per annum for DWP and around £6-15 million per annum for employers.[186] At today's values, these costs would be slightly higher. We estimate a total of £10 million for HMRC and DWP, and £7-18 million for employers.

Costs of a local income tax which applied only to earned income subject to the basic UK tax rate and which was locally set

94. The system requirements for HMRC and employers would be significantly more complex under this option given that they would be faced with up to 32 different local income tax rates. As a consequence, both set-up and running costs would be significantly higher than those for the previous option.

Costs of a local income tax which applied to earned income subject to both the basic and higher UK tax rates and which was (a) nationally set or (b) locally set

95. Under both of those options there would be additional set-up and running costs for HMRC, DWP and employers as extending local income tax to earned income subject to the higher UK tax rate would require the development of new systems beyond those which HMRC have already put in place for the SVR. For the ODPM Balance of Funding Review,[187] CIPFA calculated the annual collection costs to HMRC for a UK local income tax would be £120 million to £260 million. We assume that the Scotland-only cost would be about 10% of this range (i.e. £12 million to £26 million).

96. We have estimated the annual additional costs to employers to be £17-28 million. This is the £7-18 million estimate already referred to, with an additional £10 million which represents 10% of the additional £100 million cost to employers estimated by CIPFA for a UK-wide variable local income tax. There are two partly compensating factors to consider for the purposes of this estimate. One is that the figure might under-estimate the actual cost of this tax to employers, as many businesses based elsewhere in the UK either would or could have employees living in Scotland. The other is that this figure might over-estimate the actual cost to business, if the component parts included an element of double-counting.

186 The Scottish Office, *Scotland's Parliament*, Cm 3658 (1997)

187 *BoF(19): Reviewing the Case for a Local Income Tax* (2004)

Figure 10.3: Estimated net annual costs or savings of assessing and collecting a local income tax (applying to earned income; assessed and collected by HMRC)

	Net Additional Costs/(Savings) to Bodies			
	LAs/Assessors £m	HMRC/DWP £m	Employers £m	Total £m
Locally-Set Tax	(42)	12-26	17-28	(13)-12
Nationally-Set Tax	(42)	10	7-18	(25)-(14)

97. These cost estimates should be treated with caution. In practice, the figures are likely to under-estimate the cost for HMRC in administering a local income tax, given that HMRC would need to administer a variable local income tax for Scotland for UK-wide employers who may have Scottish resident employees.

Additional costs of applying a local income tax to income from savings and dividends as well as to earned income

98. A universal self-assessment approach could be adopted to bring investment income within the scope of local income tax. It would add substantially to the cost of tax collection: CIPFA quoted to the ODPM Balance of Funding Review a broad estimate of an additional £1.3 billion per annum to current income tax collection costs at a UK level – possibly even exceeding the expected yield from this source.[188]

OTHER ISSUES

Economic and behavioural effects of a local income tax

99. We have considered the possible effect of a local income tax on people's behaviour and on the broader economy. Quantifying the effect is extremely difficult. Many studies have produced conflicting findings. Moreover, it is difficult to draw lessons about effects of a local income tax for Scotland from experiences in other countries, where different circumstances and different tax rates apply.

100. A local income tax may have possible effects on the following:

- Propensity to work;
- Fiscal flight;
- Incorporation by the self-employed;
- Growth and GDP;
- Entrepreneurship; and
- Overall tax receipts.

188 *BoF(25)* (2004)

101. Propensity to work. A local income tax system will raise marginal income tax rates for the majority of people. Unless compensated for by increases in wages, this will have an effect on reducing net earnings and might in turn reduce work incentives. Conversely, abolition of council tax might improve work incentives for some lower-income workers and unemployed people, as the marginal tax payable under income tax would be less steep than the 20% marginal tax rate that applies to Council Tax Benefit above the income threshold for 100% benefit.

102. Fiscal flight. If a highly progressive tax system was introduced in Scotland alone, then this might create an incentive for higher income earners to migrate to a lower-taxed region. If such "fiscal flight" occurred, it would have implications for the availability of skilled and enterprising people in high-tax areas. Employers may face pressure to increase wages for higher earning staff to offset this effect.

103. A similar effect might occur if the level of taxation varied substantially between two local authority areas.

104. There appears to be little empirical evidence on fiscal flight. Kay and King have suggested that there is no strong evidence of fiscal flight between countries, suggesting that "for most people, the ties of family, home, culture and language outweigh fiscal incentives to work in other countries".[189] However, fiscal flight within countries may be more prevalent, given proximity, common language and similar culture. For instance, Bakija and Slemrod found evidence of income-rich and wealthy people moving from higher-taxing to lower-taxing states in the United States (this report found an association for inheritance and property taxes, as well as income tax).[190]

105. In the case of a local income tax for Scotland, a 6.5% local income tax on basic and higher rate earned income might cost around £6,000 for a person earning £100,000 per year. It is difficult to assess how significant an incentive that level of additional tax would be for fiscal flight. Even if movers were modest in number, the effect on overall tax receipts could be significant since a high proportion of income tax receipts come from a small proportion of the highest income earners.

106. Incorporation by the self-employed. Self-employed people can incorporate their business as a limited company or operate it as an unincorporated business. In taxation terms, a key difference is that profits by unincorporated businesses are payable through personal income tax, while profits by limited companies are payable through corporation tax.

107. Changes to the relative tax rates for income tax and corporation tax can make incorporation either more or less attractive to the self-employed. At present, no corporation tax is payable on the first £10,000 of company profits; the next £300,000 of profits is then taxed at 19%.

108. Depending on the rate at which it was set, the introduction of a local income tax could create an incentive for many self-employed people to incorporate where doing so would reduce the overall tax liability of their business. Incorporation would take the profits concerned outwith the scope of local income tax and consequently reduce overall local income tax yield.

189 Kay and King, *The British Tax System* (1990)

190 Bakija and Slemrod, *Do the Rich Flee from High State Taxes?* (2004)

109. Growth and GDP. Most studies[191] have concluded that GDP levels and/or GDP growth is negatively affected by high marginal tax rates.

110. Entrepreneurship. There is limited evidence[192] that high marginal tax rates discourage entrepreneurship.

111. Overall tax receipts. The concept known as the "Laffer Curve" provides a theoretical association between marginal tax rates and tax yield. On a simply arithmetic basis, increasing the tax rate ought to produce additional tax receipts. However, as the tax rate increases, so the incentive to work, save or invest will fall or people will become more likely to take action to avoid or mitigate tax liability. Even if the principle of the Laffer Curve is accepted, however, it is difficult to judge the effect in Scotland at any given income tax rate.

Powers to operate and enforce

112. An issue arises as to whether HMRC could administer a local income tax in Scotland, if asked to do so by the Scottish Parliament, without the need for separate Westminster legislation. Legal advice we have received indicates that Scottish Ministers and Commissioners of HMRC can enter into voluntary arrangements over the handling of their respective functions. While the collection of local taxes is not a function of Scottish Ministers but of local authorities, legal advice is that this difficulty could be addressed through legislation in the Scottish Parliament.

113. To manage the collection of an important source of revenue through the continued co-operation of HMRC in a voluntary arrangement is not a robust basis for doing so (in practical, if not legal, terms).

114. The legal advice we have received states that there would be nothing in law to prevent the Scottish Parliament from conferring functions and duties upon HMRC. However, it is likely that HMRC does not currently have the power to undertake any such functions and duties that the Scottish Parliament might impose upon it (since HMRC does not at present collect any local tax). This power could be conferred by an Order in Council.

115. Nevertheless, while the Scottish Parliament may be able to confer powers and functions upon HMRC (with or without an Order in Council), our legal advisers find it difficult to envisage how either the Scottish Parliament or Scottish local authorities could force HMRC and other UK authorities to carry out these functions.

116. A related issue concerns whether HMRC could compel employers outwith Scotland to co-operate in the administration of a local income tax that applied only to Scottish residents. Legal advice we have received indicates that regulations approved by the Westminster parliament might be necessary to give HMRC the necessary enforcement powers.

191 e.g. Koester and Kormendi, *Taxation, Aggregate Activity and Economic Growth: Cross Country Evidence on Some Supply side Hypotheses* (1989); Padovano and Galli, *Tax Rates and Economic Growth in the OECD Countries* (2001); Karabegovic, Veldhuis, Clemens and Godin, *Do Tax Rates Matter?*, Fraser of Allander Institute (2004)

192 Carroll, Holtz-Eakin, Rider and Rosen, *Entrepreneurs, Income Taxes and Investment, in Slemrod* (ed) "Does Atlas Shrug? The Economic Consequences of Taxing the Rich" (2000)

Preparatory arrangements

117. CIPFA suggested that, realistically, a minimum timescale of 4 years might be necessary before a local income tax for the UK could become operational.[193] We consider this to be an ambitious target, especially in relation to a local income tax for Scotland alone.

118. Preparation for a local income tax for Scotland would have three principal elements:

- preparation and passing of legislation at Holyrood;
- preparation and passing of supporting legislation at Westminster; and
- systems development, training and other preparatory work by HMRC and employers.

119. We anticipate that a period of at least 2-3 years would be required for the first stage. This would involve the development of policy proposals, followed by the drafting of legislation. A process of consultation would be required, preferably in relation to both the policy proposals and the draft bill, but at least for one or other of these. Once a bill is introduced to Holyrood, the process for Parliament to scrutinise, amend and ultimately pass it (with Royal Assent following) will typically take 6-12 months.

120. The timing of supporting legislation by the UK Government at Westminster would be subject to the will of the Government and Parliamentary authorities there. The fact that the necessary measures could be introduced by regulation, without the need for primary legislation, potentially both eases the hurdle of securing willingness and space to introduce the draft measure to the parliament there and reduces the time required to complete the Parliamentary process.

121. For the final stage, CIPFA estimates that HMRC and employers might require one year for systems preparation and, in parallel, two years for consultation (in the case of HMRC) and testing. A local income tax for Scotland only, or in different form for Scotland, would be more complex, as it would require HMRC and employers to operate two different systems for residents in different parts of the UK. Realistically, this stage might require 3 years to complete. It would not be practicable for this work to commence until the necessary legislative steps at Holyrood and Westminster had been completed, and the precise features of the tax envisaged were clear.

122. Overall, we anticipate a reasonable timescale to be likely to be at least 6 years before a local income tax for Scottish residents could be operational. Given the likely complexity of such a local income tax scheme, careful consideration would have to be given to the trade-off between the timing of implementation on the one hand and, on the other hand, producing a programme which is long enough both to optimise the prospects of successful implementation and to prepare taxpayers for change.

123. As part of the preparatory work, consideration would have to be given to protecting the cashflow position of local authorities in the initial period of a local income tax, given likely delays in obtaining income from self-employed earners and in confirming the tax liability of people in employment.

193 BoF(25)

Equalisation

124. An important part of the methodology for the distribution of Aggregate External Finance to local authorities is the equalisation of each authority's tax base. Because of the unpredictability of tax yield at a local authority level, equalisation of the tax base could be difficult with a local income tax. This is discussed in detail in section 19.

Treatment of second homes

125. In the case of the taxpayer with more than one home, a separate policy decision would have to be taken as to whether they should be liable to a secondary charge on top of their local income tax liability payable to the local authority area of their main residence. The Scottish Liberal Democrats told us in their oral evidence that they propose the retention of a property tax to cover second homes, either using the existing council tax as a proxy for the property or by aligning such properties with the non-domestic rates system. The latter proposal could treat second homes as if they were commercially rented properties.

Local income tax as a supplementary tax

126. Feedback we have received from members of the public who participated in the deliberative focus groups organised by GfK NOP, and who responded to our earlier consultation, reveals greater support for local income tax as a replacement for council tax than as a supplementary tax. The focus groups revealed some perceived association between the number of types of tax in operation and the total amount collected in tax, believing that a system with more than one type of local tax would increase the total tax yield.

127. As a matter of principle, it is our view that the local tax system should be kept as simple as possible. Local government receives most of its funding through UK taxes and it is impracticable to replicate the UK basket of taxes in a local tax system. Applying two or more types of local tax complicates the local tax system and increases the operational costs. We recognise there may be presentational advantages to considering a supplementary local income tax alongside a property tax, to provide a demonstrable link between local tax and income. However, the problems associated with a supplementary local income tax outweigh its benefits.

128. We asked the University of Stirling to model for the effects of a hybrid tax which would raise the same amount as council tax presently does by combining a local income tax set at 3% of earned income at basic rate with a property tax. Not surprisingly, the results of this modelling were that the hybrid tax was more progressive than a pure property tax but less so than income tax.

129. We state elsewhere that achieving a particular balance of funding should be a low priority. If it were felt important to introduce an income-related element to local taxation, it is our view that only the property element should be locally-variable. Based on the figures above, the cost of introducing and running a locally-set income tax would be substantial and – especially in the case of a supplement to another local tax – out of proportion to its likely yield.

130. We estimate the costs of a supplementary income tax to be similar to the cost of introducing and operating a local income tax which replaced council tax, but without the savings associated with abolishing council tax. Consequently, using figures from Figure 10.3 above, we estimate the annual operational costs to be in the region of £17-24 million per year in the case of a nationally-set tax and £29-54 million per year in the case of a locally-set tax.

Future of Council Tax Benefit

131. A total of £345 million was paid in Scotland as Council Tax Benefit in 2004-05.[194]

132. Funding and policy responsibility for Council Tax Benefit rests with the Department of Work and Pensions for Great Britain as a whole. Council Tax Benefit shares eligibility rules and administrative arrangements with Housing Benefit, for which DWP is also responsible. However, it does mean that, while the Scottish Parliament has powers over local taxation in Scotland, powers over local tax benefit policy are reserved to the Westminster Parliament.

133. If in Scotland the council tax were replaced by a local income tax, Council Tax Benefit would cease. We were requested by the Scottish National Party to make a recommendation that the funding presently received as Council Tax Benefit should continue to flow to Scotland. However, we have not considered this in any depth, because it is a political issue which the Scottish Executive would have to pursue with HM Treasury and the Department of Work and Pensions.

CONCLUSIONS

134. Local income tax has been considered at length by previous inquiries, such as Layfield in 1976 and the Scottish Parliament's Local Government Committee in 2002. It is the preference of the Scottish National Party, Scottish Liberal Democrats and many of our respondents. In particular, income tax is a tax that is well understood by the public and generally trusted as being fair.

135. In this section, we have considered various forms of local income tax. We concluded that any local income tax system, for practical reasons, would need to operate in parallel with the UK income tax system. As a result, a local income tax should use the same allowances and tax bands as apply to UK income tax. A local income tax should be assessed and collected using arrangements already in place for UK income tax, including the PAYE and Self-Assessment processes.

136. As a tax that would contribute towards the cost of local authority services, it seems that liability to a local income tax should be based on a person's place of residence, rather than their place of employment. However, HMRC does not compile, update or validate address records for most taxpayers at present. To introduce such a requirement would significantly increase the complexity and cost of a local income tax system.

194 Scottish Executive, *Scottish Local Government Finance Statistics 2004-05* (2006)

137. To be "fair", a local income tax should apply to all taxable income. However, while excluding income on dividends and savings would detract from the fairness of a local income tax, the cost and complexity of including them would be substantial. It is arguable that a local income tax applied, like the SVR, only to earned income at basic rate would be less "fair".

138. A nationally-set local income tax would be less complex and cheaper to apply than a locally-set tax (an estimated annual cost of £17-28 million for operating a nationally-set tax and £29-55 million for operating a locally-set tax, both offset by an annual saving of approximately £42 million from the abolition of council tax). The set-up costs for a locally-set tax would be substantially more than the estimated costs of £19 million for HMRC and DWP and the further £55-60 million for employers associated with preparing for the implementation of a nationally-set tax. A nationally-set tax would mean that 100% of local authority funding was provided by the Scottish Executive.

139. Our modelling suggests that a local income tax levied only on earned income at basic and higher rates would have to be set at a rate of 6.5% in order to replace the current council tax yield.

140. A local income tax by definition cannot raise tax from second homes or non-resident owners.

141. A local income tax would require some years to implement, including the time needed for any necessary legislation by the Scottish Parliament and any supporting legislation by the UK Parliament at Westminster.

142. Overall, we have concluded that it would not be appropriate to introduce a local income tax. There are five reasons for this.

143. First, we have already stated our view that a tax on property as a proxy for wealth should feature as part of the overall basket of taxes in the UK.

144. The second reason is that income tax already provides a substantial proportion of UK tax receipts. HMRC estimates that income tax generated 32.8% of its tax receipts in 2005-06.[195] On the assumption that public expenditure is funded in proportion to the yield from the various UK taxes, UK income tax already makes a significant contribution to the Scottish Budget and, in turn, the Scottish Executive's financial support for local government.

145. Third, the yield of a local income tax would be unpredictable, because of uncertainty and fluidity in both the number of taxpayers in any local authority area and the level of their taxable income. This would have implications for local authority budgeting processes and for the equalisation of councils' tax bases. The difficulties of unpredictable yield would be more acute for those local authorities with small populations and consequently small tax base.

146. Fourth, a local income tax could increase the overall tax burden upon households who are already paying income tax. The burden could fall most heavily upon families with more than one working adult.

195 HMRC, *Tax Receipts and Taxpayers* (http://www.hmrc.gov.uk/stats/tax_receipts/table1-2.pdf)

147. An increase in income tax on earned income would be a disincentive to work. This disincentive may increase as the population of working age shrinks.

148. Finally, we doubt the feasibility of introducing a local income tax and, in particular, we are concerned about the additional administrative burdens it might place on taxpayers, employers, local and central government. The practical problems of applying a local income tax to all categories of income are immense in the context of a UK tax system designed to maximise tax deduction at source and to minimise the need for year-end adjustments and universal tax returns.

Recommendation 2: We recommend that a local income tax should not be introduced, either as a replacement for council tax or as a supplementary tax.

SECTION 11: PROPERTY TAX OPTIONS CONSIDERED

1. In this section, we consider the second of the taxes which we concluded merited detailed further consideration – that is, a tax on property. We examine three property tax options, namely:

- Rateable value;
- Land value; and
- Capital value.

RATEABLE VALUE

2. Rateable value was the basis of valuation used for the former domestic rates system and is still used for assessing non-domestic rates. Rateable value assumes a rent at which property might reasonably be let in a free market. In principle, rateable values have advantages over capital values. They provide a direct measure of the annual value of occupation. They also tend to be less volatile than capital values, although volatility of property prices in Scotland has not been a particular problem in recent years.

3. However, there is a major problem with using rateable values for domestic property. The Scottish Assessors Association expressed concern about the robustness, complexity and cost of any valuations based on rental values. With the increased incidence of home ownership in Scotland and in the UK as a whole, there is a much smaller rental market than there was even forty years ago. So the relevance of a valuation based on assumed rental income is not clear to most taxpayers. While householders estimate the capital value of their home with a reasonable degree of accuracy, they are much less likely to calculate the rateable value of their home with any accuracy. This makes a tax based on rateable values more difficult to understand than a tax based on capital values.

Summary

4. We received very little evidence in support of rateable values being restored as the basis of valuation. For these reasons, we do not recommend this option.

LAND VALUE

5. Land value tax (also known as "site value tax") has a long history and has been promoted assiduously by the Henry George Foundation, named after the 19th century economist and leading advocate of this form of taxation. We received a limited number of submissions, including from the Henry George Foundation and the Scottish Green Party, for the replacement of council tax with a land value tax.

6. The tax has two key features. The first is that the tax applies to the value of the land and not the value of any buildings on the land. The second is that is the owner of the land, rather than the occupier, who pays the tax.

7. The basic rationale of a land value tax is that taxing land encourages owners to ensure that the land in question is used to best effect, as the tax liability will be the same whether the land is left derelict or fully utilised. Its supporters argue that standard property taxes create a disincentive to developing land and improving properties, since those improvements will in turn be taxed. In doing so, advocates of land value taxation argue that it is more progressive than council tax, because it is applied as a proportion of value without the use of bands.

8. The Henry George Foundation described another purpose of land value taxation. It is that it can provide a means through which the community or government can tax the benefit that private land receives as a result of public or community investment. For instance, in many towns the value of homes has been enhanced by the presence of a good school or transport connections nearby. These services were paid for by government, not the local householders. Income received from taxing the enhanced value of the land owned by these householders reduces the tax burden on other residents, who have not benefited from these public investments.

9. We understand that more than 700 cities worldwide apply a land value tax in some form, including cities in Australia, eastern Europe and the US State of Pennsylvania.[196] However, it appears that the proportion of revenue coming from land taxes in Denmark, Australia and New Zealand has declined over the course of the 20th century.[197]

10. Despite considerable evidence, there is no "ideal" model in operation that we could identify. That, and the absence of objective evidence on the effects of land value taxation in practice, has made it difficult for us to test the likely practical effects of the theoretical arguments in support of land value taxation.

11. Our consideration has focused on the following issues associated with a land value tax:

- Its effect on behaviours;
- Fairness;
- Public understanding of the tax;
- Its financial effects on households;
- Valuation issues;
- Taxing the owner instead of the occupier; and
- Transitional issues.

196 Craig, *Land Value Taxes and Wilmington, Delaware: A Case Study,* National Taxation (2003)

197 Scottish Parliament Local Government Committee, *Report on Inquiry into Local Government Finance*, para 69, 2002

Effect on behaviours

12. Supporters of a land value tax argue that it would promote positive behaviour in encouraging the optimum use of land and investment. External changes that require planning permissions, such as house extensions and conservatories, could increase the value of a home. No additional tax liability would arise from such changes under a land value tax.

13. The advisers supporting Mark Ballard MSP when the Scottish Green Party gave oral evidence to us confirmed that land should be valued according to its "optimum permitted use". In relation to almost all domestic property, they accepted that its permitted use is for residential use.

14. Land value taxation has the advantage over current council tax in that it would be payable on vacant and derelict land.

15. While we agree that a land value tax attached to derelict land could encourage redevelopment, so too could other fiscal measures. This issue was the subject of recent consultation by the Scottish Executive (culminating in the Council Tax (Discount for Unoccupied Dwellings) (Scotland) Regulations 2005.[197]

Fairness

16. It seems unlikely that people would consider as fair a situation where the same amount of tax was payable for two properties of different sizes, because they were located on identical parcels of land. Logically and economically, such an outcome might be reasonable but we think that most people would regard it as unfair.

Public understanding of the tax

17. This is a factor which impinges closely on the issue above. Taxpayers must understand how the tax operates if they are to accept the tax as being fair.

18. As discussed above in relation to domestic rates, capital values have the advantage of being clear, known and relevant to most householders. It seems that few householders would be familiar with the value of the land on which their home is located.

Financial effects of a land value tax on households

19. It is not clear that a tax based on a theoretical value of the site rather than on the property on that site would necessarily be seen as progressive by this publication at large.

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20. In the absence of meaningful data elsewhere, we asked the Henry George Foundation if they could substantiate their claims about the financial differences that would arise from the introduction of a land value tax in practice. They produced a comparison between the average council tax bill and the average land value tax bill, by band and before the application of Council Tax Benefit. Figure 11.1 is an updated version of that comparison.

Figure 11.1: Comparison of average council tax and LVT bills by band[198]

COUNCIL TAX BAND	AVERAGE COUNCIL TAX BILL (2006-07)	AVERAGE LVT BILL (2006-07)
A	753	254
B	878	531
C	1,004	770
D	1,129	1,039
E	1,380	1,463
F	1,631	2,066
G	1,882	3,707
H	2,258	6,582

21. The Foundation acknowledges that the methodology used in these calculations is relatively primitive and unsophisticated, but they believe they are sufficiently robust and reliable for the purposes of this study. We have no evidence which either supports or challenges these results.

Valuation issues for land value taxation

22. A common feature of proposed, pilot and actual schemes elsewhere is the use of CAMA (computer-aided mass appraisal) system to record and value parcels of land. This is a tool that is not restricted to land value tax systems. For instance, the Valuation and Lands Agency in Northern Ireland is using CAMA for the purposes of revaluation as part of the forthcoming reforms to their domestic rates system.

23. At its simplest level, a land value tax could be applied through measurement of the area covered by the ground of a home. Even if achievable (see below), this basis of valuation would not be sophisticated enough to take account of factors that might influence the value of land locally, such as the provision of good schools or transport links locally or attractive topographical features. The inclusion of such adjustments, which are fundamental to a land value tax, will complicate the valuation process.

198 Workings and assumptions set out in Annex A

24. We understand that a number of possible methods exist that could be used for the valuation of land parcels for the purpose of a land value tax. However, we are concerned that no basis of valuation can provide the volume of direct and demonstrable supporting evidence as exists for capital values. RICS Scotland indicated to us that, while evidence will exist of individuals and developers acquiring land for residential development, analysis of these transactions may not be straight-forward.

25. In the absence of sufficient direct evidence of the values of land-only transactions, valuation for the purposes of land value taxation would have to use house sales data (this was the basis for valuation for a recent pilot project in England[199]). This process would require building values to be identified and disregarded, with values relating to the size and location of the land being included in the valuation. This process would be subjective to some extent. We are concerned that it could generate a large number of appeals, because of the likely levels of public uncertainty about both the definition of land value and the way the valuation had been calculated.

26. There is concern over the valuation of buildings in multiple occupation or ownership. In this case, a value for the site of the building would be calculated, and this would then have to be apportioned among each of the occupiers in the building. Variations in value might occur from different uses within the building (e.g. retail use on the ground floor, storage use on the first floor, residential use on the top floor). RICS Scotland stated to us that there is likely to be reasonably robust evidence for capital values relating to such properties, but evidence for site values or the apportionment of site values would be sparse.

Taxing the owner instead of the occupier

27. Advocates of a land value tax argue that, for the tax to act as a stimulus to optimising use of land, it should be payable by the owner of the land. While this distinction has no practical effect for owner-occupied homes, it would mean that land value tax in the rented sector would be payable by landlords instead of tenants. In practice it is reasonable to assume that sooner or later it would be added to the rent.

28. Collection of local tax may become more difficult. While occupied property does not move, its owners can. Unlike occupiers, owners are not always readily identifiable. Local authorities could face difficulties in pursuing payment from some landlords, short of taking formal action such as attaching a charge to the land.

29. If local taxation makes any contribution towards local accountability, it must be payable by people who live in the area served by a local authority and who benefit from the services provided. Under this principle, it is appropriate for a local tax to be levied on the occupier (or, in the case of second homes, on the person whose ownership prevents it being occupied by another person).

199 Oxfordshire County Council & Vale of White Horse District Council, *The Oxfordshire Land Value Tax Study* (2005)

Transitional issues

30. Commentators who advocate the introduction of a land value tax have suggested that it should be introduced initially in pilot form.[200] This is not because of uncertainty amongst these supporters about the benefits of such a tax. To quote a recent report about how land value taxation might be implemented in Britain:[201]

> "Pilots will merely help develop and test the processes and stages necessary for a national implementation and prove that the benefits outweigh the costs."

Summary

31. Although land value taxation meets a number of our criteria, we question whether the public would accept the upheaval involved in radical reform of this nature, unless they could clearly understand the nature of the change and the benefits involved. Nor might they accept a situation where reform to local taxation was delayed in order to allow details of a replacement scheme to be tested by pilot schemes

32. However, we considered at length the many positive features of a land value tax which are consistent with our recommended local property tax (see section 14), particularly its progressive nature.

CAPITAL VALUE

33. Capital value is based on the market value of a property. Therefore it has the benefit of being clearly understood. There also is clear and considerable market evidence for capital valuations from the buying and selling of owner-occupied property.

CONCLUSION

34. Having considered both rateable value and land value as the basis for taxation, we concur with Layfield who recommended that any local property tax should be based on capital values.

35. In the following sections we consider against the criteria three models that use capital value as their basis. These are:

- current council tax;
- a reformed council tax; and
- the local property tax.

200 e.g. Connellan, *Land Value Taxation in Britain: Experiences & Opportunities* (2004)
201 Vickers, *A Blueprint for Smart Tax in Britain*, Lincoln Institute of Land Policy (2003)

SECTION 12: CURRENT COUNCIL TAX

INTRODUCTION

1. Council tax was introduced in 1993, replacing the Community Charge which had been in force in Scotland for four years. Its introduction was received well by the public, being seen as considerably fairer than the Community Charge and easier to understand than its predecessor, domestic rates.

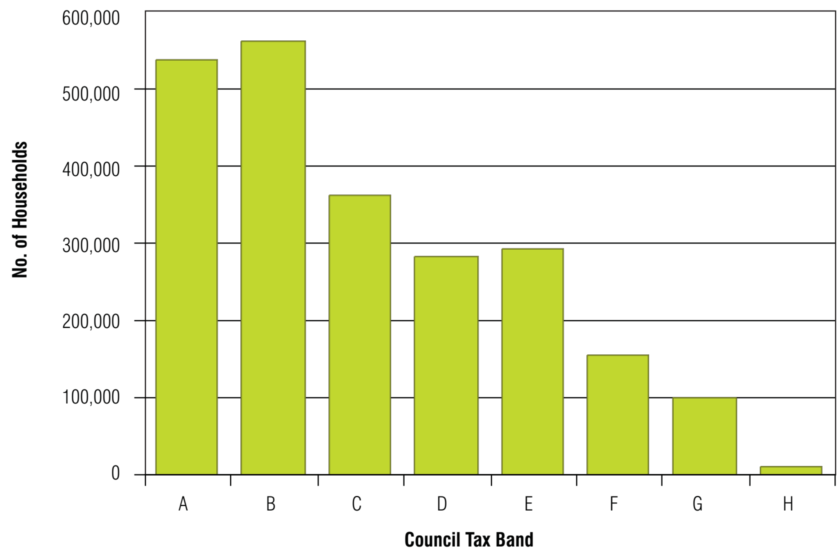
2. As indicated in section 9, the council tax is a hybrid tax with property, personal and, through the operation of the Council Tax Benefit scheme, income-related components. The 2.26 million domestic properties are each allocated to one of eight bands (A to H) on the basis of the value of the property at 1 April 1991. There has been no revaluation of domestic properties since then. The distribution of the council tax burden amongst the eight bands is determined by a "multiplier" formula. Overall, the multiplier means that the tax payable by the highest band (H) in any local authority area is three times that for the lowest band (A). The bands and the multiplier between bands are shown in Figure 12.1 below:

Figure 12.1: Council tax band limits and multiplier

Council tax band	Upper limit (1991 values)	Multiplier
A	£27,000	6 / 9
B	£35,000	7 / 9
C	£45,000	8 / 9
D	£58,000	9 / 9 (i.e. 1)
E	£80,000	11 / 9
F	£106.000	13 / 9
G	£212,000	15 / 9
H	n/a	18 / 9 (i.e. 2)

3. As shown in Figure 12.2, nearly 50% of all properties are in Bands A and B, while Bands G and H contain less than 4%.

Figure 12.2: Number of households by council tax band



4. A system of exemptions, discounts and disregards applies to the council tax. Some properties are entirely exempt from the tax. Properties occupied by certain categories of person are also fully exempt. Some categories of unoccupied properties are exempt on either a time-limited or indefinite basis. Reflecting the personal component of the tax, discounts are available for single person occupancy of a property and for second and long-term empty properties. The 25% single person discount applies to over 900,000 properties. Certain categories of persons are disregarded for the purposes of determining whether or not a single person discount is applicable.

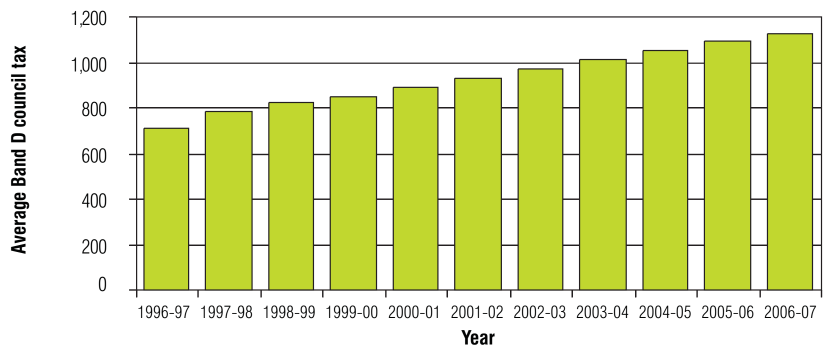
5. To the best of our knowledge, the council tax system in Great Britain is the only banded property tax system in the world.

6. Our consultation produced very limited support for retention of council tax in its present form. As part of the representative sample survey undertaken for our Committee by MORI Scotland, participants were asked for their opinions on a number of types of tax currently in operation. Of these, 60% of respondents stated that they were dissatisfied or very dissatisfied with council tax. This compares with dissatisfaction ratings of 69% for petrol duty, 35% for VAT and 32% for income tax.[201]

7. Many responses to our consultation from members of the public have highlighted criticism about the scale of annual increases in council tax bills and their effect on certain sections of the community, especially pensioners and others on fixed incomes. Figure 12.3 below shows the average year-on-year percentage increase in average Band D council tax. As discussed in section 7, many local authorities put this situation down to the "gearing effect" by which, because only a small proportion of local government funding comes from local taxes, even modest increases in overall council spending require large percentage rises in local taxes.

201 See Figure 1 and Table 1

Figure 12.3: Average Band D council tax in Scotland 1996-97 to 2006-07[2]



8. The scale of discontent with council tax should be set in context. In their report analysing the results of the public survey, MORI Scotland commented that concern about council tax has never exceeded 4% in MORI's monthly "Most Important Problem" poll (in contrast, the community charge reached a peak figure of 52%). This is a relevant point for policy-makers, as it suggests that clear expressions of concern about council tax and council tax levels should not be confused with a general perception amongst the public that this is a high priority area for reform.

ASSESSMENT AGAINST CRITERIA

9. We have assessed the effectiveness of council tax against the same criteria on which our consideration of other tax options is based.

Macro-economic criterion

10. Section 9 discussed the potential effects of a property tax on the economy. Although commonly regarded as such, council tax is not a pure property tax. The non-linear multiplier gives a substantial personal element to the tax. For instance, a household in a Band H home worth £1 million today pays only three times as much as a household in a Band A home worth £40,000 today (25 times less). The personal element is further enhanced by the single person discount. As we discuss in section 14, evidence suggests that a more proportionate property tax might have significantly more effect on property prices than council tax.

202 Scottish Executive, *Council Tax Data*

Fairness-related criteria

11. The principal reasons amongst the public for disaffection with council tax are its perceived lack of fairness (defined in section 8) and its disproportionate impact for people with limited means. This was reflected in the MORI Scotland survey for our Committee. Of those respondents who were dissatisfied with council tax, 54% said it is too expensive, while 31% said it is unfair. It was also reflected in responses to our consultation paper, where perceived fairness was overwhelmingly the key issue.

12. Likewise, the GfK NOP survey identified "overwhelming criticism of council tax",[203] with comments that council tax is expensive and places an undue impact on pensioners and low-income households. Taxing property is seen as being inappropriate, as property values are not perceived to reflect ability to pay and because of the impact on "asset-rich, cash-poor" households. Unlike income, wealth tied up in property is not immediately accessible for the purposes of paying tax. Concern about the effect of council tax on pensioners is particularly strong (although this may have been influenced by topical news stories of the time from England about the conviction of pensioners for non-payment).

13. Help the Aged in Scotland also expressed strong concern about the effect of council tax on many pensioner households, particularly single pensioner households and other 'asset rich but income poor' households. Their submission stated that combined council tax and water and sewerage rates are usually the second biggest item of expenditure in a pensioner household (after food) – averaging 11% of net income (13% over the 10 months of the year when council tax is payable).

14. The fact that Help the Aged have chosen to link the separate items of council tax and water and sewerage rates together is significant. As we discuss in section 20, there is considerable scope for confusion in that many people apparently see their "council tax bill" as the sum of their actual council tax liability and water and sewerage charges.

15. Available evidence suggests that there is a general relationship between income and property levels, although there are also a sizeable number of exceptions (see Figure 12.4 below).

16. Because the data from the Family Resources Survey and the only property valuation data available relate solely to the bands rather than the actual values, it is very difficult to get a definitive answer to the question as to how strong the relationship really is. The statistical correlation between income and band appears to be low at around 0.3. But it is not clear to what extent this is a function of the numbers of "outliers" and the fact that valuation calculations assume the mid-point of each band.

203 See section 3.3.2

17. There is a clear association between households on low incomes and households living in dwellings covered by council tax Band A (72% of households in Band A lie in income deciles 1 to 5). Households in Bands B and C, and to a lesser extent Band D, are distributed across all the income deciles. Beyond Band C, households become increasingly concentrated in the higher income deciles. Recent research suggests that incidences of apparently low income in high valued properties were associated with fluctuations in income.[204] The question really is "How much of any household's income does council tax take?"

18. We have used this data to estimate the prevalence of "asset rich, cash poor" households, which live in relatively expensive houses despite having a modest income. The figures show that around 8% of households in income deciles 1 to 3 live in a property in Bands E to H. But they account for only 2% of all households in Scotland and in absolute numbers amount to around 50,000 households. We consider the position of "asset-rich, income-poor" pensioner households in section 16.

Table 12.4: Approximate distribution of households by income and council tax band[205]

Figures in thousands (Percentage of all households in Scotland)

Decile	Band A	Band B	Band C	Band D	Band E	Bands F to H
1	102 (4.6%)	62 (2.8%)	29 (1.3%)	21 (1.0%)	12 (0.5%)	6 (0.3%)
2	91 (4.1%)	53 (2.4%)	25 (1.1%)	18 (0.8%)	9 (0.4%)	6 (0.3%)
3	89 (4.0%)	57 (2.6%)	27 (1.2%)	13 (0.6%)	10 (0.4%)	7 (0.3%)
4	84 (3.8%)	53 (2.4%)	29 (1.3%)	20 (0.9%)	10 (0.5%)	7 (0.3%)
5	53 (2.4%)	63 (2.8%)	40 (1.8%)	28 (1.2%)	22 (1.0%)	7 (0.4%)
6	50 (2.2%)	56 (2.5%)	38 (1.7%)	37 (1.6%)	29 (1.3%)	9 (0.5%)
7	44 (2.0%)	57 (2.5%)	37 (1.7%)	37 (1.6%)	28 (1.2%)	26 (1.3%)
8	29 (1.3%)	49 (2.2%)	41 (1.8%)	46 (2.1%)	38 (1.7%)	30 (1.5%)
9	28 (1.2%)	41 (1.8%)	38 (1.7%)	44 (2.0%)	52 (2.4%)	41 (2.1%)
10	14 (0.6%)	25 (1.1%)	25 (1.1%)	42 (1.9%)	60 (2.7%)	86 (4.4%)

19. For council tax to be seen as fair, it requires the existence of an effective benefit system. The existing Council Tax Benefit scheme is extensive, and forms an essential part of the council tax system. Some 24% of households in Scotland receive Council Tax Benefit, roughly half of which include at least one person age 60 or over. Of these, among three-quarters receive full Council Tax Benefit. Some half of Band A households, and one-third of Band B households, receive Council Tax Benefit. Around 80% of recipients live in homes in Bands A or B.[206]

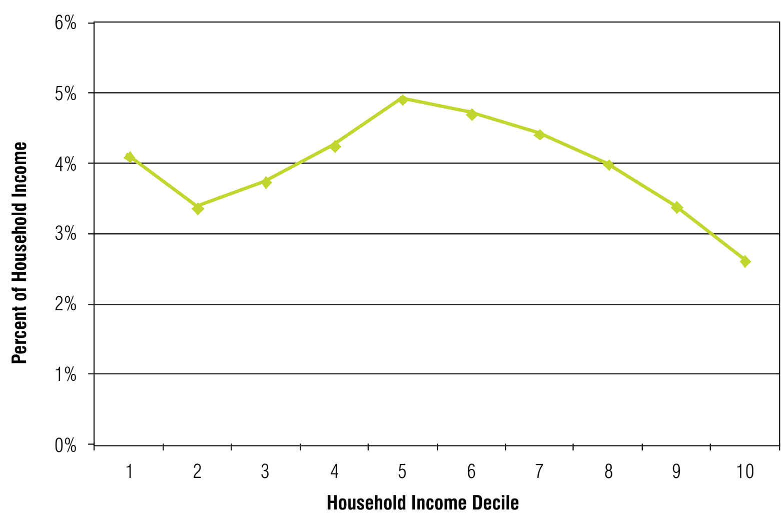
204 Orton, *Struggling to Pay Council Tax: A New Perspective on the Debate About Local Taxation,* Joseph Rowntree Foundation (2006)

205 Provided by University of Stirling using data from Family Resources Survey 2003-04. Figures should be read as indicative only.

206 Statistics based on Department of Work and Pensions data for May 2004

20. Figure 12.5 was produced by the University of Stirling. It shows how the share of equivalised household income spent on council tax varies by income decile, after taking account of Council Tax Benefit and discounts. Among the upper deciles, there is a general downward trend in the burden of council tax, so that it is equal to around 2.5% of income for those in the top income decile. The burden of council tax appears to be high in the lowest income decile compared with the second decile. This is because of the Family Resources Survey contains a number of households with very low incomes which do not appear to be eligible for council tax benefit, perhaps because of income instability or self-employment. It then drops steeply at the second decile, where the effects of council tax benefit become stronger, then applies at around 4% for income deciles 3 and 4, around 5% for deciles 5 and 6 and declines thereafter.

Figure 12.5: Net council tax as a share of net household income before housing costs



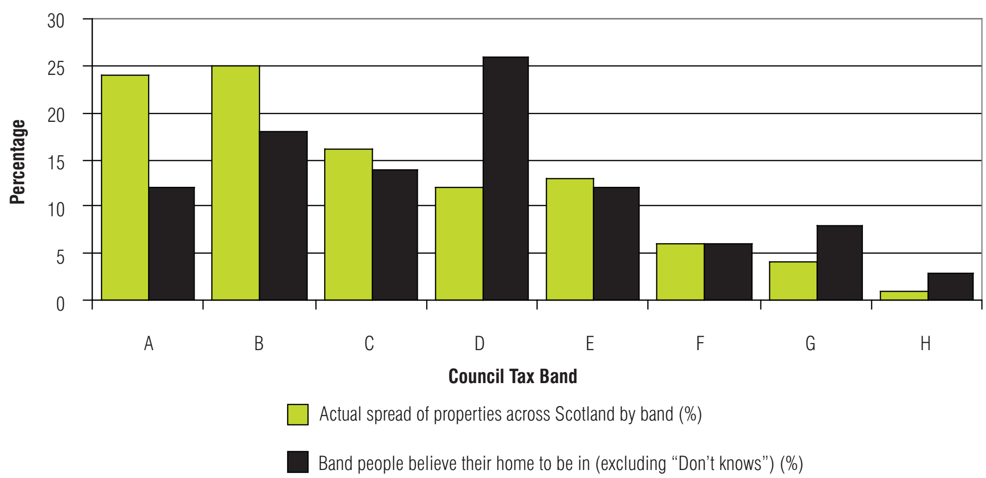
21. ODPM's Balance of Funding Review group described a positive feature of council tax as being that its basic principles are easy to understand. Responses from the deliberative focus groups led by GfK NOP tended to echo this, although income tax was perceived to be simpler still to understand.

22. Council tax is a clearly comprehensible payment. While income tax under PAYE is deducted at source and VAT is hidden within a retail price, the council tax bill is a discrete entity, posted each year to each household in Scotland. Households have to take positive measures to ensure that they meet their liability to pay council tax, whether it is setting up a direct debit mandate, for example, or physically travelling to a council office to pay in person.

23. Most participants in the deliberative focus groups carried out by GfK NOP felt that the present council tax system is straight-forward. However, GfK NOP also reported that most participants found the property banding system for calculating tax liability unclear. It is not surprising that people should find it difficult to associate their property with a particular tax band, because of the arbitrary nature of the upper limit of each band and the fact that the bands are based on market values that are now 15 years out of date.

24. The MORI Scotland representative sample poll also suggested quite poor public awareness as to which band a respondent's home falls. Many people (35% of respondents) stated that they did not know what band their own property falls into. The distribution of other results was significantly different from the actual breakdown of properties by band in Scotland, as Figure 12.6 shows:

Figure 12.6: Comparison of perceived council tax bands and actual distribution of houses in Scotland across council tax bands



Assessment and collection criteria

25. Property-based taxes – including council tax – are difficult to evade, because they relate to people's homes which are immobile.

26. Some local authorities were perceived by our respondents to be poor at collecting council tax. Those who pay promptly argued that this is unfair because they are subsidising the non-payers.

27. The average in-year collection rate for council tax in 2004-05 was 92.7%, ranging from 85.6% of the income due for the year to 97.3%.[207] Audit Scotland reports that the variation between authorities in collecting council tax has diminished since 1996-97, due in large part to significant improvements in collection rates by several of the poorer performing councils.[208] A recently published research report for the Scottish Executive highlighted how the inclusion of water and sewerage charges alongside council tax bills is a factor that makes it difficult for local authorities in Scotland to match the collection rates of authorities in England and Wales.[209]

207 Audit Scotland, *Statutory Performance Indicators: Council Profiles 2004-05*

208 Audit Scotland, *Corporate Management Performance Indicators 2003-04: Comparing the Performance of Scottish Councils* (2005)

209 Scottish Executive, *Improving Council Tax Collection Rates in Scotland,* by Bramley, Karley, Rutherford & Wager, Heriot Watt University (2006)

28. However, the very same results can be interpreted in different ways, according to a particular view about council tax more generally. Local authorities argue that council tax collection rates are very good, and improving. Against this, a number of respondents to our recent consultation were critical of recent collection rates. Behind these comments tended to be views that there is little reason why collection rates could not be at or close to 100% and that councils are not trying hard enough to catch residents who are evading the tax. The Scottish Liberal Democrats and Scottish National Party also view collection rates as being low, although the SNP acknowledged in their submission to us that collection rates have improved in recent years.

29. On the related issue of how easy the methods to pay are, local authorities offer a range of options for paying council tax, including by post, telephone or in person at a range of locations, or by direct debit. It is possible to pay council tax bills in instalments. Usually this means ten monthly instalments between April and January, with no bill being payable in February or March. To the best of our knowledge, only a small number of councils provide residents with the option of 12 monthly payments. As we discuss in section 14, having to pay a year's bill in a ten month period can make council tax bills more challenging.

30. Turning to the costs of collecting council tax, those members of the public who responded to our consultation who cited high collection costs also tended to link this to a perception that council bureaucracy is too great and that HMRC could collect the necessary funds more cheaply through income tax. A sizeable share of the cost of collecting income tax falls on employers, a fact often overlooked when collection costs are cited.

31. The cost of collecting council tax ranged in 2004-05 from £6.81 per dwelling to £24.99. The Scotland average was £13.23[210]. In addition, the Scottish Assessors' Association (SAA) estimates that the annual recurrent cost of maintaining the Council Tax Valuation List is around £1.2 million. SAA estimates that a revaluation under the current system might cost a further £4.7 million. The average administration cost per Housing Benefit and Council Tax Benefit case was £48.22 per application in 2004-05.[211]

32. CIPFA in Scotland has quantified these administrative costs as mounting to around £30 million per annum across Scotland (or $1^1/_2$-2% of council tax yield).[212] This is a benchmark figure against which we assess the cost of other options later.

Yield-related criteria

33. Council tax offers the stability and predictability of all property taxes. The taxbase is stable from year to year. Furthermore, the anticipated council tax yield can be known in advance, because households are charged a fixed and pre-set sum of money.

210 Audit Scotland, *Statutory Performance Indicators: Council Profiles 2004-05*

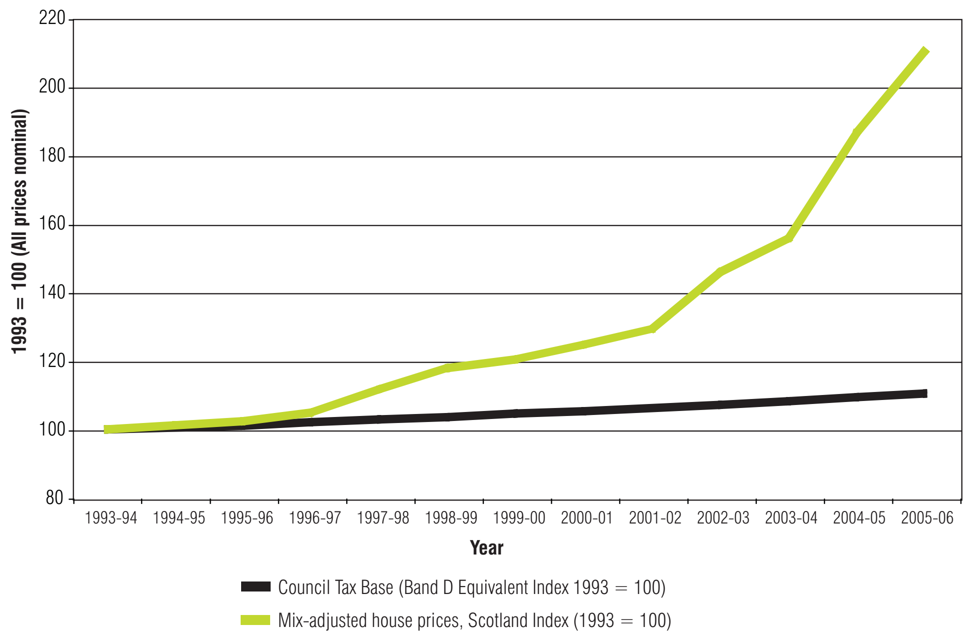
211 Audit Scotland, ibid: The performance indicator they use combines Council Tax Benefit and Housing Benefit applications.

212 CIPFA in Scotland, *Rating Review Estimates of Income and Expenditure.*

34. For households themselves, this means that they know at the start of the financial year precisely how much council tax they are going to have to pay during that year. In most instances, unless the household moves to another home, that bill will not change even if the household undergoes a major change in circumstances during the year (e.g. redundancy). The council tax system relies on Council Tax Benefit being available to provide support for households whose ability to pay council tax diminishes in-year.

35. Council tax is not inherently buoyant. As Figure 12.7 shows, the council tax base rose by only 10.5% between 1993 and 2005. What buoyancy there is has been due largely to an increase in the number of houses. In the same period, mix-adjusted house prices rose by almost 90%.[213]

Figure 12.7: Indices of Band D Equivalents and ODPM Mix Adjusted Nominal House Prices in Scotland 1993-2005



Accountability and balance of funding criteria

36. The size of the tax base for council tax reflects the taxbase which applies to property taxes generally. As discussed in section 9, there are an estimated 2.26 million households in Scotland in 2006. With the number of households projected to increase in the coming years, this is a taxbase that is likely to increase in size for the foreseeable future.

37. Council tax is clearly identifiable as a local tax: it is billed and collected locally. Tax rates are also set locally, which local government interests (including most local authorities, COSLA and SOLACE) argue is an important element of local accountability. As we explain in section 6, we received no objective evidence to support this argument.

213 Audit Scotland, ibid: The performance indicator they use combines Council Tax Benefit and Housing Benefit applications.

38. A key justification for council tax is that it is important that a tax on the continued enjoyment of property should feature as part of the overall basket of taxation. The corollary of this is that the extent to which a property tax, or any tax for that matter, can reasonably contribute as part of that basket is limited. In particular, the role of council tax is limited by the fact that it is based on wealth (in the form of property values) and not income. Consequently, council tax is not capable of responding flexibly and effectively to changes in the balance of funding. We note that the Scottish Parliament's former Local Government Committee concluded, as did the Institute of Revenues Rating and Valuation, that council tax ultimately should not make up any more than 25% of local government income.[214]

Implementation criterion

39. Any issues about changing to a new system of local government finance do not really apply to council tax, as the system which is already in place.

CONCLUSIONS

40. Council tax is a valuable element in the basket of UK taxes. However, its shallow, non-linear multiplier makes it more onerous on households with modest incomes than on higher-income households. In terms of its effect on the economy, the fact that the size of council tax bills do not differentiate greatly between homes of different value restricts its effectiveness in moderating fluctuations in property prices – potentially a key benefit of a property tax.

41. We believe that council tax in practice shares the administrative merits of property taxes in principle. It is reasonably simple and inexpensive to collect and provides a stable and predictable yield. For local authorities, its main limitations are that it does not inherently offer a buoyant yield and it would be unlikely to cope comfortably were the balance of funding to be weighted more towards local government.

42. For taxpayers, council tax offers the advantage of being easy to understand. However, we take the view that it has fundamental shortcomings. In particular, we are not satisfied that council tax is as progressive as it might be, nor that the link between it and households' ability to pay is adequate. In addition, we believe that measures would need to be adopted to make council tax easier to pay.

Recommendation 3: We recommend that council tax should not be retained in its current form.

214 Scottish Parliament Local Government Committee, *6th Report 2002: Report of Inquiry into Local Government Finance,* para 50

SECTION 13: REFORMING COUNCIL TAX

INTRODUCTION

1. This section considers whether or not the council tax can be reformed in a way that would significantly redress the problems identified in the previous section, primarily the regressive nature and poor apparent correlation with ability to pay.

2. Previous reviews on this subject, including the 2002 Review of Local Government Finance by the Scottish Parliament's then Local Government Committee and the ODPM Balance of Funding Review group, have argued that there are important advantages in retaining council tax in updated form.

3. The Committee received many submissions arguing that the council tax could be reformed by one or more of the following changes, which are considered below:

- Increasing the number of bands;
- Changing the multiplier between bands; and
- Revaluation.

INCREASING THE NUMBER OF BANDS

4. Nobody suggested the complete removal or restructuring of the banding system. There is widespread support for additional bands to be inserted at the top and bottom of the scale, to enhance fairness. Such calls have been made by most of the local authorities that responded to our consultation, as well as the Scottish Labour Party, CBI Scotland and UNISON.

5. In terms of public support, participants in the deliberative focus groups led by GfK NOP liked the idea of an increase in the number of council tax bands. However, this change, even if combined with a steeper multiplier, was not enough to overcome their deeper concerns about the regressivity of council tax.

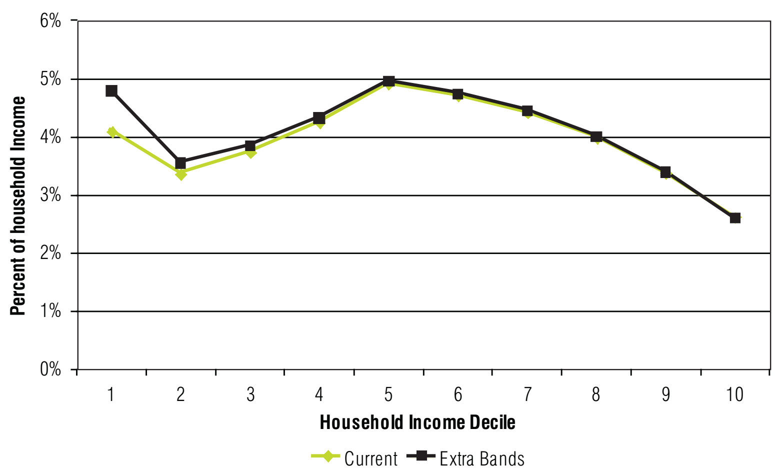
6. At the bottom of the property ladder some 50% of properties currently lie in Bands A and B. It was suggested that the spread of households within each band should be evened out. Additionally, some witnesses (including the SAA) have pointed to properties of greatly different value that lie within Band A: for example, static caravans and some social housing have very low capital values. Proposals for change have focused on splitting Bands A and B into three or creating a new band amongst the lowest value properties in Band A.

7. While some properties do have a very low capital value, the peak of numbers of properties within Bands A and B is largely a reflection of the fact that there are many homes of similar value within those bands. To try to create additional bands within this group might be perceived to be arbitrary and to represent unfair treatment towards those householders who would have a higher tax liability related to the "benefit" of residing in a home with a marginally higher value than others.

8. The rationale for extra bands at the top of the property ladder is to make the system more progressive and to enhance the perception of fairness between individual households. One method of doing this would be by splitting Bands G and H into three. However there is also a view that more bands should be added to reflect the very broad spread of properties at the top of the ladder.

9. The University of Stirling's modelling work concluded that "introducing additional council tax bands has virtually no effect on the burden of council tax", as Figure 13.1 shows.

Figure 13.1: Effect of increasing number of council tax bands from 8 to 16 by income decile



10. These results are consistent with the outcome of research by Heriot-Watt University for the Scottish Parliament's former Local Government Committee. Although the results appear to be counter-intuitive, we also note that Sir Michael Lyons was surprised to find that adding additional bands would not appear to have a significant impact in making council tax relate more closely to ability to pay.[215] This seems to be due largely to the fact that households with diverse levels of income can be found in every council tax band in England.

CHANGING THE MULTIPLIER BETWEEN BANDS

11. As explained in section 12, at present council tax has a multiplier of three. This is a shallow multiplier, as the difference between the respective values of properties in Bands A and H is substantially more than three times.

12. There was strong support amongst local government interests for making the council tax multiplier steeper to enhance fairness. Figures of up to 10:1 were proposed in submissions.

215 Lyons, *Interim Report and Consultation Paper,* paras 2.76-2.77 (2005)

13. In terms of public support, participants in the deliberative focus groups led by GfK NOP liked the concept of a steeper multiplier. However, while they welcomed this and other suggested reforms to council tax, they were not satisfied that these changes were sufficient to address their deeper concerns about the regressive nature of the council tax.

14. As part of the modelling work undertaken for us, the University of Stirling undertook a series of experiments, to test the effects of changing the multiplier between Bands A and H. Although the number of scenarios that could have been considered were limitless, the scenarios tested were as follows:

- Scenario 1 – increasing the multiplier from three to seven. In this scenario, the tax payable at each band was changed from ninths to fifths.
- Scenario 2 – increasing the multiplier from three to 14. In this scenario, the multiplier approximates the difference in the capital value of houses in Bands A and H. Data on house prices from the Scottish Assessors Survey suggest that the ratio of the price of Band A and Band H houses sold in 2005 was 14.2 (with the average Band A house in Scotland selling for £45,000, while the average Band H house sold for £645,000).
- Scenario 3 – increasing the multiplier from three to 42. In this scenario, the multiplier approximates the ratio between the annual income of a single person on income support and someone earning £100,000 per year. This is around 42.

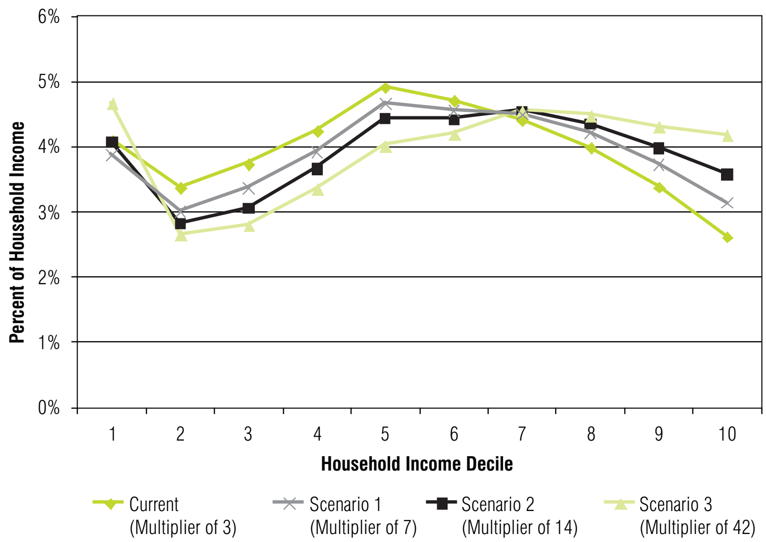
15. The ratios between each of the eight bands at present and under each of the above scenarios is shown in Figure 13.2.

Figure 13.2: Ratios used under experimental changes to the council tax multiplier

CT Band	A	B	C	D	E	F	G	H	Multiplier
Current	0.67	0.79	0.89	1	1.22	1.44	1.67	2	3
Scenario 1	0.4	0.6	0.8	1	1.4	1.8	2.2	2.8	7
Scenario 2	0.25	0.5	0.75	1	1.63	2.25	2.88	3.5	14
Scenario 3	0.125	0.375	0.625	1	2.06	3.12	4.18	5.25	42

16. The results were adjusted so that the same yield was achieved in each scenario.

Figure 13.3: Ratio of new council tax bill to net equivalised household income by household income decile

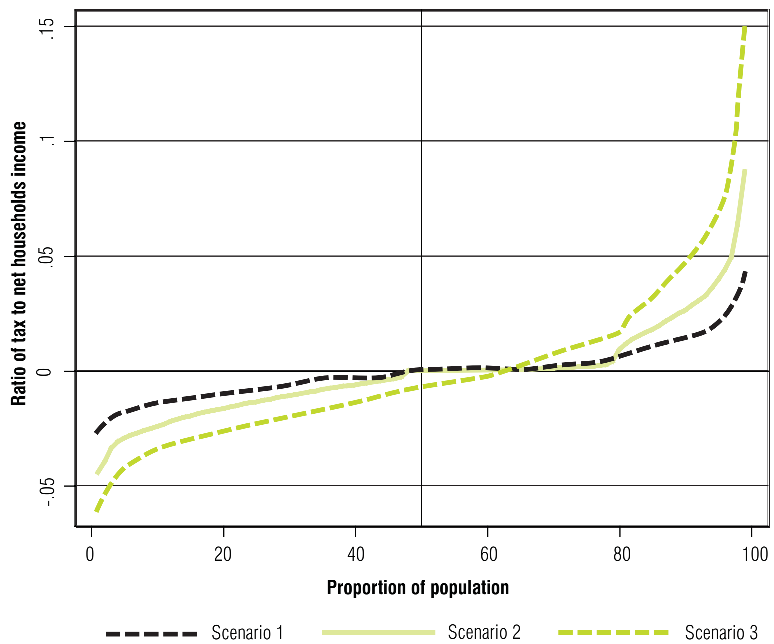


17. As Figure 13.3 shows, increasing the multiplier makes council tax more progressive. As a result, the council tax payable by households in income deciles 1 to 6 declines in most instances,[216] while beyond income decile 6 the decline in the proportion of net household income accounted for by council tax declines more slowly than under current council tax.

18. The University of Stirling undertook further work on the effect these changes would have on different types of household. The results suggested that single adult households would gain from increasing the ratio of Band H to Band A council tax, because single adults are more concentrated among lower council tax bands. These gains would be greatest with Scenario 2. Scenario 3 would be less advantageous to single adult households, perhaps because the small number of them who live in dwellings that are in the higher council tax bands disproportionately affects the average council tax burden for this group.

216 There is an exception in the bottom decile for the "income" experiment, because of the number of houses in high council tax bands occupied by low income households and because a proportion of these households are not eligible for council tax benefit.

Figure 13.4: Gains and losses for households relative to current council tax structure



19. Figure 13.4 shows that for all three scenarios, the majority of households either gain from the change in the multiplier or are unaffected (more than 50 per cent of the population either experience a gain or no change). The maximum gain is around 5 per cent of net income for Scenario 3 and, as we might expect, this scenario also generates the largest loss, of around 15 per cent.

20. The more progressive the council tax structure, the larger the share of households that are at least as well off. But as the structure of council tax becomes more progressive, the losses of those who are made worse off by the changed structure increase. Thus, the more progressive the scheme, the greater the proportion of the population who gain, but those who lose do so more heavily. This finding is quite consistent with any tax whose structure is being altered but whose yield is being held constant: the more who gain, the greater the cost to the losers.

21. All three scenarios were based on a continuation of the current 8 band structure.

22. However, a tension emerges about the optimum number of bands. As the council tax was made more progressive, so the variation of tax payable at adjoining bands would increase. This scenario, where a small increase in the value of a property can result in a substantial increase in council tax liability, is sometimes described as a "cliff-edge effect". The present difference between the average amount payable by adjoining bands is shown in the following figure:

Figure 13.5: Difference in amounts payable in 2006-07 between adjoining bands based on average Scottish council tax figures

Bands	Difference in amount payable
A-B	£125
B-C	£125
C-D	£125
D-E	£251
E-F	£251
F-G	£251
G-H	£376

23. The "cliff-edge" effect means that a small difference in the 1991 value of a property can make a significant difference in the amount payable each year in council tax. For example, a householder in a property worth £59,000 in 1991 (that is, just falling within Band E) has to pay just over 22% more each year than someone living in a property worth £57,000 in 1991 (that is, just below the upper limit for Band D). It is questionable whether this is fair to the Band E householder.

24. Increasing the multiplier between bands would widen the difference in the amount payable by adjoining bands – in the case of above scenario 3, considerably so – and accentuate the "cliff-edge" effect. The larger the multiplier, the greater the "cliff-edge" between each of the bands.

25. The position outlined in the previous paragraph could be mitigated to some extent by increasing the number of bands, so that the step-change between each band decreases. However, a large number of bands would be required before the "cliff-edge" impact of increasing the multiplier was offset and the more bands that are created, the closer a banded system becomes to one where properties are valued individually. Furthermore, throughout this debate, there is no reason why the thresholds for bands should be set at any one value over any other value – it is an arbitrary process with the potential to fuel further discontent.

REVALUATION

26. Another way that has been suggested to improve council tax as a property tax is to update the property valuations on which it is based. The existing system is based on property values 15 years ago, in 1991.

27. For the purposes of our Report, we have assumed that the purpose of a revaluation would be to distribute the existing tax burden in line with up-to-date property values and not to increase the overall tax yield.

28. Both our Committee and the Scottish Parliament's former Local Government Committee (LGC) (during its 2002 inquiry into local government finance) have received strong statements of support for revaluation, particularly from local authorities and professional organisations like the Chartered Institute of Public Finance and Accountancy (CIPFA) and the Institute of Revenues, Rating and Valuation (IRRV). Indeed, the LGC recommended (at para 49 of its Report) in favour of early revaluation.

29. The Committee strongly supports the principle of regular revaluation and considers the matter in detail in section 14. However, we are not persuaded that a revaluation on its own (or in combination with changes to the bands or multiplier) would overcome the shortcomings of the current system.

CONCLUSION

30. The Committee has carefully considered the proposed reforms discussed above. We are not satisfied that any banded system can be improved sufficiently to overcome its inherent shortcomings.

31. We have therefore examined a different capital value option which is considered in the next section.

SECTION 14: THE LOCAL PROPERTY TAX

INDIVIDUAL PROPERTY VALUATIONS

1. In the previous section, we concluded that a banded property tax could not be reformed sufficiently to overcome its fundamental problems.

2. We recommend a root and branch reform of local domestic taxation, based on individual valuations of properties. We call our recommended model the "local property tax" or LPT. Under LPT, banding would be abolished and tax would be charged as a percentage of the capital value of each property. LPT would be payable by households occupying properties (whether as owner-occupiers or as tenants) and by the owners of second homes and unoccupied properties.

3. We considered whether the LPT should include an element of charging for services and concluded that it should be a tax and have no such element. Consequently, we concluded that there is no logical justification for discounts for single occupant households or on second homes. This issue is examined in greater detail later in this section.

4. Unlike the council tax, the LPT would have no arbitrary number of bands set at equally arbitrary thresholds, and no cliff-edge effects associated with these thresholds. Unlike the former domestic rates system, the LPT would be based on individual capital values, a concept with which most taxpayers are readily familiar.

5. A revaluation of domestic properties would be an essential requirement for the introduction of LPT. Thereafter, an integral feature of LPT is regular revaluations, to ensure that tax liability is based on valuations that are as up-to-date as possible. We discuss this in greater detail later in this section.

6. Results from our modelling suggest that in 2006-07 the LPT we recommend set at an average of around 1% of current market values would produce a more-or-less equivalent total yield across Scotland to the current council tax yield. So a house worth £100,000 would incur a bill of approximately £1,000. The LPT being levied as a percentage of the property value would be more progressive than is council tax at present, particularly for properties both at the bottom and at the top of the property ladder. A household living in a Band A home currently worth £40,000 and paying on average £750 in council tax would be liable for a LPT bill of around £400 in 2006-07. If a Band G house was now worth, say, £400,000, it would attract a bill of £4,000 under LPT, instead of a typical £1,880 bill at present.[217]

ASSESSMENT AGAINST CRITERIA

7. The LPT performs well against the criteria we are considering.

217 Typical council tax bills are derived from Scotland-average band D bill of £1,129 in 2006-07 (source: http://www.scotland.gov.uk/Topics/Statistics/Browse/Local-Government-Finance/DataCTLevelbyBand2006-07)

Macro-economic criterion

8. In terms of its effect on the economy, the LPT should have a greater effect than council tax on house prices, although the extent of this is unclear. Muellbauer and Cameron suggest it is likely that the reintroduction of a local property tax (albeit in the form of the old domestic rates) could reduce house prices in the long run perhaps by 15%[218] on average.

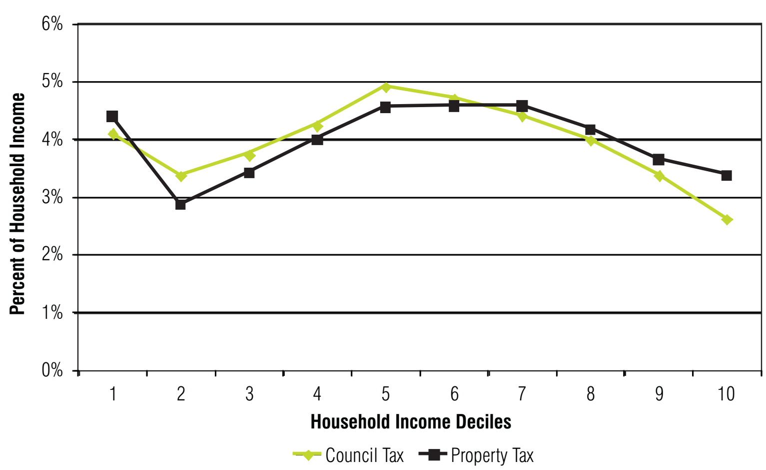
9. The introduction of LPT will mean that some properties will attract more tax liability than the current council tax and some less. This leads to the possibility that, other things being equal, house prices will change, either up or down, in response to the individual change to tax liability. Thus at the higher end of the market property prices may moderate whilst at the lower end they may increase.

10. A more progressive property tax theoretically could create an incentive for higher income earners to migrate to a lower-taxed region. As discussed in section 10 in relation to a local income tax, if such "fiscal flight" occurred, it might have implications for the availability of skilled and enterprising people in high-tax areas. However, as indicated earlier, there appears to be little empirical evidence on fiscal flight.

Fairness-related criteria

11. Being more progressive than the council tax, the LPT would offer a reduction in tax liability for households in lower income deciles, with an increase in tax for households in higher income deciles. For example, households in income deciles 2 to 6 would spend between 3% and 5% of their equivalised net income before housing costs on a property tax (see Figure 14.1). The results for income decile 1 are counter-intuitive and may be due to unstable income or self-employment. At higher income levels, the LPT would be less regressive than the council tax (although, unlike council tax, no upper limit on liability has been proposed for LPT).

Figure 14.1: Share of net local property tax in equivalised net household income by income decile

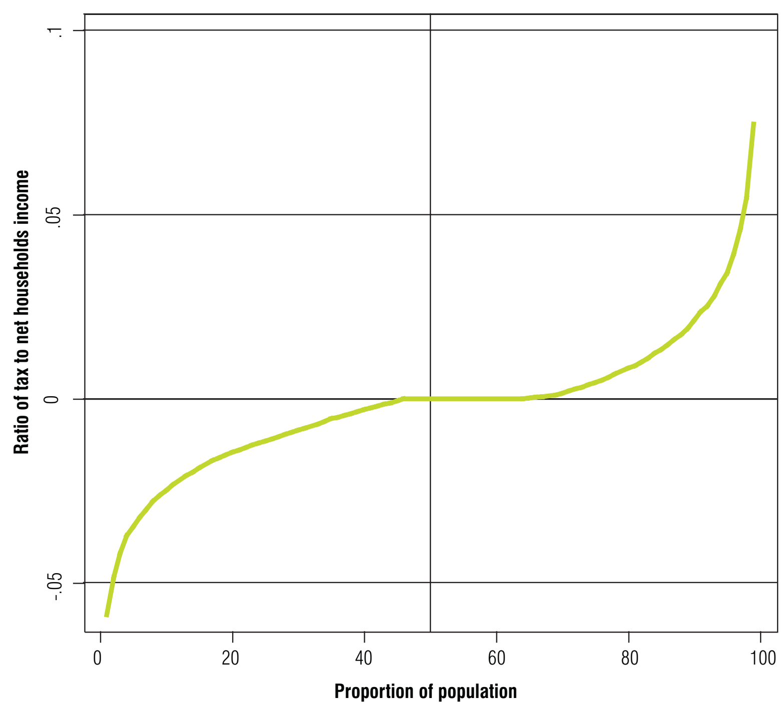


218 See Muellbauer and Cameron, ibid

12. Further work by the University of Stirling to break down property tax by type of household indicated that households with two or more adults would typically benefit from the local property tax, while single adult families might lose out. This suggests that some single adult families occupy dwellings whose market price would exceed their current council tax valuation.

13. Overall, the modelling suggests (see Figure 14.2) that around half of households in Scotland should pay less tax under LPT than under council tax, while around two-thirds in all would be no worse off than at present.

Figure 14.2: Effect of a local property tax on households – winners and losers



14. Following discussion with DWP officials and receipt of legal advice, we would not expect eligibility for Council Tax Benefit to be affected by the proposed changes.

15. In terms of comprehensibility, LPT should be straight-forward for householders to understand. Taxpayers could estimate their tax liability as a specific percentage of the value of their home. They would not have to associate their home with a particular property band, nor would they have to understand how the banding system works.

Assessment and collection criteria

16. The LPT would be as difficult to evade and easy to collect as the council tax. In terms of costs, it would not be significantly more expensive to assess, and would be no more expensive to collect.

Yield-related criteria

17. The yield of LPT would be as stable, predictable and buoyant as council tax. Gross revenue to councils would remain unchanged. The overall consequence of a reduction in the LPT liability for benefit recipients would be a reduction in the amount of Council Tax Benefit payable in Scotland. However, because of the greater progressivity of a local property tax, the higher yields from the more valuable properties would offset this reduction.

Accountability and balance of funding criteria

18. The LPT would be identifiable as a local tax. As a component within the overall basket of UK and local taxation, the LPT would have the same characteristics as all property taxes in its ability towards altering the balance of funding.

Implementation criterion

19. The process of implementation should be straight-forward. In contrast to the complexity of introducing an entirely new tax, such as a local income tax, the framework for LPT is largely in place, although it would require a revaluation. Implementation issues are discussed further later in this section.

POSSIBLE VARIANTS

20. The Committee discussed a number of possible variations to the general principle of a local property tax (including features of present council tax and new options). These include:

- Exemptions;
- Discounts and disregards;
- Varying liability according to number of working adults;
- Minimum and maximum payments; and
- Differential treatment of second homes.

Exemptions

21. As indicated in section 12, some properties are exempt from the council tax either indefinitely or for a limited period. There are a number of different categories of exemption, briefly as follows:

a. Indefinite exemptions

22. Occupied property. Examples of properties in this category are:

- Dwellings that are solely occupied by students;
- Dwellings that are the sole or main residence only of people under the age of 18; and
- Dwellings that are solely occupied by the severely mentally impaired.

23. Unoccupied property. There are 11 different categories of property which are exempt on a without time limit basis. Examples are:

- Unoccupied dwellings where the person liable to pay the council tax has moved to receive personal care;
- Unoccupied dwellings where the person liable to pay the council tax has moved to provide personal care;
- Unoccupied dwellings where the liable person is in prison (except for non-payment of a fine); and
- Dwellings whose occupation is forbidden by law or impending compulsory purchase.

b. Time-limited exemptions

24. There are five categories of time limited exemptions (of varying lengths) which all apply to unoccupied property. Examples are:

- Dwellings that are unoccupied and (except for dwellings owned and last occupied by a charity) unfurnished are exempt for up to 6 months;
- New dwellings are exempt for up to 6 months as long as they remain unoccupied and unfurnished; and
- Dwellings in need of substantial repair/reconstruction are exempt for up to 12 months from the last date of occupation.

25. We received a submission from the Central St Andrews Residents Alliance expressing concern about a shortage of affordable housing in St Andrews and arguing that the problem is so extreme the town's young people are forced to move elsewhere. A principal cause is an over-heated buy-to-let housing market. The Alliance argued that the cause of this is the council tax exemption for properties solely occupied by students. They further argued that this exemption in practice benefits landlords, through the application of market forces on the local housing market, rather than students themselves.

26. We also received a submission from Stewart Maxwell MSP suggesting that troops serving abroad should be exempt from paying the council tax. It was not clear whether Mr Maxwell had in mind a property exemption or a personal disregard.

27. We envisage the LPT as a property tax (albeit underpinned by the equivalent of the Council Tax Benefit scheme) rather than a property/personal hybrid tax, which the council tax is. Therefore, exemptions for certain categories of property would be compatible with LPT. All the current exemptions could consequently be retained or the opportunity could be taken to review them.

Discounts and disregards

28. As also indicated in section 12, and reflecting the personal component of the council tax, a 25% discount is available for single person occupancy and a discount of between 10% and 50% applies to second homes (and long-term empty dwellings). The position of second homes is discussed below.

29. There are also 15 categories of person who are disregarded for the purposes of council tax. This means that the bill for the property is calculated as if the person disregarded was not there. Examples include students, student nurses, patients in residential care and certain care workers.

30. From an economic and logical standpoint, there are strong arguments for not applying across-the-board discounts or disregards to classes of person for a local property tax. Categories of person that qualify for discounts and disregards under council tax at present, such as single occupiers, are not inherently synonymous with inability to pay. In this respect, a particular household's lack of ability to pay a tax should be covered by an individual benefit or rebate. The use of blanket discounts or disregards for a particular category of persons reduces the size of the overall tax base and is not economically efficient.

31. If, as a result of the removal of discounts and disregards, overall expenditure on Council Tax Benefit increased in Scotland, then we understand that the Scottish Executive would be liable to compensate DWP for that additional expenditure. We also recognise that, where there is a strong correlation between a particular category of person and restricted ability to pay, it may be more cost-effective to apply a blanket disregard or discount than to subject households within the category to means-testing.

32. As indicated above, we conclude that there is no logical justification for any personal discounts or disregards in relation to LPT. However, we recognise that the decision about whether or not any such discounts or disregards should continue will ultimately be for Ministers to make.

Varying council tax according to the number of working adults

33. One suggestion that emerged from the GfK NOP research was that council tax should take "more account of the number of working people in each household", i.e. that those households with more than two working adults should face larger bills than they do at present. Anecdotal evidence from a number of respondents to our consultation included complaints that they were on a limited income and yet still had to pay as much in council tax as their neighbours with three or four working adults living in the same household.

34. Some 9% of households in Scotland contain three or more adults.[219] For these purposes, an adult is any person over the age of 16 and so this statistic will include, for instance, an elderly relative or a person aged over 16 in full-time study. Around 6% of households contain 3 or more working adults.[220]

35. We calculate that the additional yield that could be raised from such a measure would be modest (a 25% surcharge on council tax bills from 9% of households might increase yield by around 2%). Although irrelevant in principle, the fact that this measure would provide little additional revenue in practice is worthy of note. The fairness of the measure would also be open to question. If the test is that larger bills should be paid by households with three or more working adults, this does not necessarily translate as households with relatively high ability to pay. If they are in higher-paid employment, then their household will already be contributing more towards the funding of their local authority, by paying more in UK income tax.

36. Such a measure would give a property tax some of the characteristics of a poll tax, liability for which depends largely on the number of adults residing in a home. This of itself might be unwelcome to many taxpayers. It also would require the introduction of more complex administrative arrangements. As council tax stands at the moment, households only have to apply to their local authority if they believe they are entitled to an exemption or discount. In other words it is in these taxpayers' own interests to inform their council of their circumstances. To introduce a higher payment for households of three or more working adults would require local authorities to compile and maintain a register of these households. Experience of the community charge suggests that these processes would be difficult and expensive to operate effectively.

37. In conclusion, we rejected this proposal. It is inconsistent with the principle of a property tax, would be administratively complex and disproportionately expensive to assess and collect.

Minimum and maximum payments

38. Given the wide range of property values across Scotland, there would be a very considerable variation between the highest and lowest local property tax bills. We understand from the SAA that, in 2005, values of properties sold across Scotland ranged from around £4,000 to £5 million. Under the LPT, a rate of 1% would produce an annual bill ranging from £40 to £50,000. We considered whether there should be minimum and/or maximum payments.

219 General Registers Office for Scotland, Household Projections for Scotland: 2004-Based (2006)

220 General Registers Office for Scotland, *Census* (2001)

39. The argument for a minimum payment is that all households should contribute at least a pre-defined minimum amount towards the cost of local services. Those people on low incomes should be helped by the benefit system. A minimum payment would ensure that there was an appropriate tax burden on those who were able to pay.

40. This argument has some validity. Means testing is ultimately a matter of opinion as to whether all should be required to contribute with rebates for those who cannot afford to pay their proportionate share.

41. On balance we see insufficient justification for requiring a minimum payment under LPT. Such a measure would effectively introduce a form of poll tax, as well as undermining the progressivity of LPT.

42. In considering a maximum payment, we recognise that the spread of the value of properties in Scotland is not a normal distribution, as shown in Figure 12.1. There are relatively few properties above the value where a cap might be considered appropriate. There are two factors that are important in any change to the incidence of property tax in Scotland. The first is the possible macro-economic consequences resulting from an application of very high local property tax. The second is that the aggregate amount raised from high value properties would be insignificant.

43. A cap on the maximum could apply to either the valuation of property or the tax payable. The effect on a household's tax bill would be the same. A cap on valuation could reduce the work for Assessors, because they would not be required to provide exact values for properties in excess of the cap. The advantage of applying the cap to the tax payable is that the individual valuation of each property would retain flexibility for Ministers to alter the cap in years between revaluations.

44. An alternative to a cap would be a taper in the form of a reducing percentage rate above a certain valuation.

45. The Committee recognise the argument that it is important for the LPT to be perceived as "fair". Whether a cap at a high level undermines perceived fairness is a matter of personal political perspective. Decisions about whether or not minimum and/or maximum payments should be introduced are political judgments, and we therefore offer no firm recommendations on this point.

Treatment of second homes

46. Under council tax, owners of two or more dwellings received until 2005 a discount of 50% on homes other than their main residence. Local authorities now have discretion to apply a discount of between 10% and 50%.

47. The second homes discount under the council tax reflects both the personal element of this tax and the assumption that second home households will consume less of the local authority services. Discounts logically would be justifiable if they were applied to charges for (unused or lesser used) services. In relation to council tax, we received a number of expressions of support for the recent changes that allow the discount to be reduced to 10%. In oral evidence, Argyll & Bute Council argued that no discount at all should apply to second homes.

48. There is no logical reason why there should be any reduction in a property tax, as opposed to a reduction in a charge in respect of (unused) services. The Committee recommend that the LPT should be payable with no discount for second and subsequent homes.

OTHER KEY FEATURES AND CONSEQUENCES OF LPT

49. Our detailed consideration of LPT takes account of issues surrounding:

- Revaluations and the valuation process;
- Making LPT easier to pay;
- Equalisation; and
- Timing and transitional arrangements.

Revaluations and the valuation process

50. Regular revaluation is an essential element of all property taxes and a local property tax cannot be introduced without revaluation. A property tax must accurately reflect relative differences in the values of homes throughout Scotland. If the price of all properties changed at the same rate, then it would not matter whether the property tax reflected house values of last year, ten years ago or fifty years ago. But they do not and a property tax based on outdated values is unfair. All revaluations create "winners" and "losers". However, so too does the failure to conduct revaluations, with the "losers" being those people who currently pay more than they would if up-to-date house prices were used to determine their tax. There is no compelling reason why council tax at this point of the first decade of the 21st century should be based on property values in 1991.

51. Both the Committee and the Scottish Parliament's former Local Government Committee (LGC) (during its 2002 inquiry into local government finance) received strong statements of support for revaluation, particularly from local authorities and professional organisations like CIPFA and IRRV. Indeed, the LGC recommended (at para 49 of its Report) in favour of early revaluation.

52. There is strong support for an early revaluation and for regular revaluations thereafter. Local authorities' preference appears to be for a regular cycle of revaluations every five years, scheduled in the period between revaluations of business properties. The Scottish Assessors' Association (SAA) recommended revaluations at least every 10 years, and saw merit in both non-business and business revaluations being conducted every 5 years on separate cycles. The concept of regular revaluation is also supported by RICS Scotland, ICAS, SRPBA, CBI (Scotland) and UNISON.

53. However, there is concern about revaluation from members of the public, apparently out of fears that it would be used substantially to increase council tax payable. This Report takes as given that the result of revaluation would be yield-neutral.

54. Research by Heriot-Watt University for the Scottish Parliament's former Local Government Committee suggested that property values in Scotland changed significantly between 1991 and 2002, with major regional variations in the pace of change. The University of Stirling work for us using the "MARTY" formula supports the continuing trend.

55. Business properties in Scotland are already revalued every 5 years for the purpose of assessing non-domestic rates.

56. Under LPT, we recommend that domestic properties should be subject to regular revaluations. Initially this would be every 5 years but the ideal would be to move to annual revaluation. The SAA suggest that that is an objective achievable in the relatively near term. The revaluation cycle should be underpinned by statute.

57. Routine regular revaluations are essential to protect the integrity and credibility of LPT. Over time they should reduce the sensitivity of members of the public, as they become more confident that the purpose of revaluation is to keep property values up-to-date and not to increase tax yield.

58. We understand from the SAA that a revaluation would include the following stages:

- Assessment of property values on an "average condition" basis. Assessors would estimate changes in property values since the last revaluation. The Committee recommend that properties be valued on the basis that they are of "average condition." The Committee also recommend that internal improvements, such as a new kitchen or bathroom, and even external improvements which of themselves would not require planning permission to a property be ignored. This exclusion is designed to encourage householders to maintain their property in as good condition as possible without the need for internal inspections as a standard requirement.
- Assessment of properties against revised values. Properties would be assessed on the basis of their deemed value on the "Antecedent Valuation Date", which typically precedes valuation itself by 2 years (although it is possible that this could be reduced to one year). SAA already holds data about properties (e.g. number of rooms, floor area, property type, age), which can be updated where necessary. They could apply a standard value per square metre to a range of properties of a type that clearly fitted within a particular band.
- Appeals process. A 3-stage appeals process operates in Scotland: (i) to the Assessor; (ii) to Valuation Appeals Committees, and (iii) to the Court of Session. The final appeal route to the Court of Session is available only where the dispute relates to a point of law.

59. For the LPT, the revaluation process would require specific market values to be given to each dwelling in Scotland. Initially, this would be a slightly more onerous exercise than a revaluation based on bands, where the need for accurate valuations is limited to ensuring that each home is placed in the correct band. Just how onerous this task would be will vary from location to location. It is likely to be greatest in rural areas, owing to lower housing density, greater diversity in property types and fewer market transactions. Less difficulty should arise in more urban areas, especially in valuing incidences of similar properties in the same street or estate.

60. Since the last revaluation, sophisticated Computer Aided Mass Appraisal (CAMA) software systems have become available. The current revaluation in Northern Ireland is supported by a CAMA system. SAA believes that a suitable system could prove effective in Scotland in the longer term, especially if regular revaluations enabled assessors to benefit from an initial investment in technology and associated training. In general, the usefulness of a CAMA system would be greater in urban areas, where large numbers of similar properties could be valued quickly, than in rural parts of Scotland. A question may arise as to whether the necessary preparatory work (including procurement, development, testing, data migration, implementation and training) could be undertaken in time to enable a CAMA system to be used as part of an early revaluation.

61. Certain consequences would flow from the need for individual valuations. One would be the need for a sufficient pool of expertise to undertake the valuation work. Assessors may have to train new staff and temporary workers in order to ensure sufficient resource and expertise to conduct the valuation work.

62. A possible consequence would be a risk that a larger number of householders would appeal against the accuracy of valuations, especially since (unlike for many households under a banded system) any consequent reduction in valuation automatically would reduce tax bills. However, because there would no longer be the cliff-edge effect of changing bands, the benefit to the householder of a marginal reduction in the local property tax would be less and this militates against appeals.

63. SAA acknowledge that a system based on capital values should be easier to justify to taxpayers than the old rating system. The SAA reported on their experiences with domestic rate revaluations, where Assessors had faced a large number of appeals and had faced difficulty in explaining the concept of notional rental values to householders. They told us that, over the years, the domestic rating system became ever more complex.

64. Under LPT, certain measures would help to reduce the potential burden of appeals. These include clear explanations for the public about how a new valuation system would work and a system of early notification to householders about the likely result of the revaluation on their home. (The SAA portal provided useful information on likely values before formal rates notices were issued following the last non-domestic rate revaluation).

65. The following steps could be taken after the revaluation of properties:

- Households would be notified of the provisional valuation for their home, and given an indicative LPT bill based on this new valuation;
- Households would have the opportunity to query valuations informally; and
- Values for every dwelling in Scotland would be loaded onto a website and made publicly accessible, to allow households to compare the valuation for their home with other properties.

66. The SAA suggest that a recurring revaluation process might be slightly shorter for domestic properties than for non-domestic rates if capital value was used as the basis of value, as records of property transactions held by Registers of Scotland would allow Assessors to recalibrate values relatively easily.

67. The SAA provided us with estimated figures for the costs of revaluation, which they warned should be treated with some caution. They estimate that the cost of undertaking a revaluation under the LPT would be around one-third more than under council tax at present. They estimate the cost of a domestic revaluation, if not carried out at the same time as a non-domestic property revaluation, to be £4.7 million for a banded council tax and £6.2 million for LPT. If carried out at the same time as the non-domestic property revaluation scheduled for 2010, a domestic revaluation is estimated to cost £9 million in the case of council tax, and £12 million for LPT. If the domestic revaluation was postponed until 2011 or 2012, the SAA estimate the figures would reduce to £8 million and £10.25 million respectively.

68. Excluding these costs for revaluations and associated appeals, the SAA estimate that the cost of maintaining a domestic property valuation list would be slightly higher under the LPT than under council tax at present (estimated to be £1.7 million per year cf. £1.2 million).

69. The Committee conclude that the benefits of regular revaluations on an individual property basis far outweigh the incremental cost involved.

Making LPT easier to pay

70. In their document *Council Tax: A Path to Poverty?*, Help the Aged in Scotland stated that:

> "By paying Council Tax and Water Rates over a 10-month period older people are put under considerably greater financial pressure than if they had to pay the bill over a 12-month period."

71. They reported that 70% of pensioner households were found to be paying more than 10% of their net income on council tax and water and sewerage charges during the 10 months. The 70% figure dropped to 53% of pensioner households if looked at over 12 months of the year.

72. Both Help the Aged in Scotland and Citizens Advice Scotland believe the option of either 12 monthly instalments or 13 four-weekly instalments (which is one of the options available for receipt of the State pension) can make a meaningful difference to low-income households (both pensioner and non-pensioner), who find it difficult to save from one month to the next.

73. We understand from COSLA and the CIPFA Directors of Finance Section that some local authorities already offer residents the option to pay council tax over 12 instalments. It is not clear to us why more councils do not offer this option. However, COSLA suggested that there are two main concerns. First, the "free" months in February and March, when council tax is not payable, give councils the opportunity to pursue recovery action against late payers before the end of the financial year. The second concern is that existing regulations may require any arrangements for paying tax over more than 10 instalments to be updated annually (except for direct debits, which are deemed to roll forward to the following year automatically).

74. Both COSLA and the CIPFA Directors of Finance Section recognise that there may be merit in local authorities making the ability to pay by 12 monthly instalments more widely available, particularly under direct debits.

75. We recommend that the option of payment by 12 or 13, rather than 10, instalments should be offered to all taxpayers. We further conclude that consideration should be given to introducing this change for payment of council tax bills in 2007-08; that is without waiting for the introduction of our proposed local property tax.

Equalisation

76. The revaluation required for LPT would change the tax base for individual local authorities. The implications on the process of equalising local authorities' tax bases are discussed in section 19.

Timing

77. Our proposals involve significant change to current council tax arrangements. Implementation will take time. As with any substantive reform, sufficient consideration will be required to ensure the necessary preparatory work is fulfilled to allow for timely implementation, and also to minimise turbulence in the intervening period.

78. The essential element of the preparatory work to implement LPT will be the revaluation process. We understand from the SAA that the earliest realistic date for the revaluation exercise is 2010, meaning updated property values from the revaluation would apply to tax bills issued for financial year 2010-11. Using the revaluation process for non-domestic rates as a basis for comparison, this would suggest that the revaluation work would take place throughout most of 2008 and 2009, using 1 April 2008 as the Antecedent Valuation Date. Updated valuations might appear on the SAA portal from November 2009, which would allow a period in which households could query valuations to Assessors informally before tax notices for financial year 2010-11 were produced in February or March 2010. A formal appeals process could then apply against valuations once households had received their tax notice.

79. Combining a domestic revaluation with the business revaluation already scheduled for 2010 would stretch resources available to Assessors for conducting and managing the revaluations and would also increase the overall cost of revaluation. Pressure on resources and additional costs would also apply if a domestic property revaluation took place in 2011, although to a smaller extent than in 2010.

80. Regardless of when LPT was introduced, we recommend that as much advance notice be given about timescales as possible. The credibility of LPT depends on people having time to learn about and understand the tax and on minimising the risk of serious setbacks in its implementation.

Transitional arrangements

81. Transitional arrangements frequently are used to phase in over a period of time the tax increases for households whose tax liability will increase significantly as a result of the changes. For example, transitional arrangements which follow all non-domestic revaluations were introduced after the recent domestic revaluation in Wales and features as part of domestic rate reform in Northern Ireland. Because LPT is more progressive, self-financing transitional arrangements would mean that those in lower-value properties would be subsidising those in higher-value properties.

82. An alternative to self-financing transitional arrangements would be the provision by the Scottish Executive of short-term funding to provide cushioning during the transitional period.

83. We conclude that transitional arrangements should not be necessary for LPT.

CONCLUSIONS

84. We have concluded that LPT performs well against our criteria. It would be substantially more progressive and consequently "fairer" than the council tax, with most households in Bands A to C benefiting from the change. It would be identifiable as a local tax and the size of the taxbase would be identical to the council tax base. It should be straight-forward for householders to understand, as taxpayers could estimate their tax liability as a specific percentage of the value of their home. It would be difficult to evade and easy to collect. In terms of costs, it would be not significantly more expensive to assess and no more expensive to collect. Its yield would be as stable, predictable and buoyant as council tax.

85. Exemptions for certain categories of property would be compatible with LPT. All the current exemptions could consequently be retained or the opportunity could be taken to review them.

86. We conclude that there is no logical justification for any personal discounts or disregards in relation to LPT. However, we recognise that the decision about whether or not any such discounts or disregards should continue will ultimately be for Ministers to make.

87. LPT cannot be implemented without revaluation. Routine regular revaluations will be essential to maintain the integrity and credibility of the tax. We cannot over-emphasise that revaluations should be, and be seen to be, yield-neutral in overall terms.

88. We have considered how the LPT might be made easier to pay. The option of 12 or 13 instalments should be offered to all taxpayers. (This is a change that should be made immediately in relation to current council tax.)

89. We conclude that transitional arrangements should not be necessary for LPT.

Recommendation 4: We recommend that a new local property tax (LPT) should replace council tax. LPT would be assessed as a proportion of the capital value of homes in Scotland.

Recommendation 5: We recommend that the LPT should be payable with no discount for second and subsequent homes.

Recommendation 6: We recommend there should be regular statutory revaluations not less than every 5 years; ideally on an annual basis.

Recommendation 7: We recommend that all households should be offered the option of paying LPT in 12 or 13 instalments and consideration should be given to making this option available under the council tax from 2007-08.

SECTION 15: COUNCIL TAX BENEFIT

IMPROVING THE OPERATION OF COUNCIL TAX BENEFIT

1. Although a reserved matter, a major source of comment and complaint from many respondents to the Committee was the complexity and difficulties of Council Tax Benefit. Some obvious improvements could be made, most of which are under discussion between Department of Work and Pensions (DWP) and other interested parties.

2. Council Tax Benefit is paid to those eligible for payment and deducted from their council tax bills by local authorities who administer the scheme (which applies throughout GB) on behalf of DWP.

3. There are around 535,000 household recipients of Council Tax Benefit in Scotland,[221] accounting for around 25% of households. Of these, around 77% receive 100% benefit and therefore have no net council tax bill to pay (however they remain liable to pay water and sewerage charges which are collected by local authorities, a process which creates considerable confusion and difficulties – see section 20). The local authorities with the largest proportion of households in receipt of Council Tax Benefit are Glasgow City (37%), West Dunbartonshire (34%), Inverclyde (31%) and Dundee City (30%). At the other end of the scale are Aberdeenshire, East Dunbartonshire and East Renfrewshire (all 14%).[222]

4. Around half of Band A households, and slightly less than one-third of Band B households, receive Council Tax Benefit, as Figure 15.1 below shows :[223]

Figure 15.1: Proportion of households in each council tax band that are in receipt of Council Tax Benefit

Council Tax Band	A	B	C	D	E	F
Share of Households in Band	49%	30%	18%	7%	4%	3%

5. Recipients of Council Tax Benefit by band are as follows:[224]

Figure 15.2: Spread of Council Tax Benefit recipients by tax band

Council Tax Band	A	B	C	D	E	F+	Total
Share of Total Recipients	49%	32%	12%	4%	2%	1%	100%

221 DWP, *Housing Benefit & Council Tax Benefit Quarterly Summary Statistics* (updated Feb. 2006)

222 DWP, *Housing Benefit & Council Tax Benefit Quarterly Summary Statistics* (updated Feb. 2006)

223 DWP. Small numbers of households in Band G also receive.

224 DWP.

6. We have considered what reforms to the benefit system might make council tax itself more acceptable than it is at present. There is strong support for reform from local authorities, local government organisations and, for example, Help the Aged. Calls for reform have covered several areas. One suggestion is that Council Tax Benefit should be extended to apply to water and sewerage charges that are collected in Scotland alongside council tax. This issue is examined in section 20. The other suggestions – increasing savings limits, improving take-up rates by simplifying the application process and reducing the time required to process benefit claims – are considered below.

7. Sir Michael Lyons has made clear that he believes the most direct way to improve fairness within the council tax system is by reforming Council Tax Benefit.[225] He expressed particular concern about low take-up figures.

8. We consider a number of options for improving the operation of Council Tax Benefit, namely:

- Improving take-up rates;
- Increasing the savings limit;
- Rebranding Council Tax Benefit; and
- A supplementary benefit scheme for Scotland.

Improving take-up rates

9. DWP estimates take-up of Council Tax Benefit among those eligible to receive it throughout Great Britain. The most recent published figures relate to 2003-04.[226] They indicate overall take-up levels then as being in the ranges of 63-68% (in terms of caseload) and 65-71% (in terms of benefit expenditure). Take-up rates were highest among eligible lone parents (87 95% by caseload; 88-96% by expenditure). Take-up was lowest among eligible pensioners (53-59% by caseload; 56-63% by expenditure).

10. The DWP report reveals that eligible non-recipients (both non-pensioners and pensioners) were more likely to be eligible for partial Council Tax Benefit than eligible recipients (82% of recipients were entitled to full Council Tax Benefit, as opposed to 39% of eligible non-recipients). It also suggests that a relatively large proportion of eligible non-recipients (compared with recipients) lived in more expensive housing, as non-recipients were more likely to be eligible to more than £16 benefit per week (the average benefit paid weekly at the time was £12.34 for Great Britain and £11.69 for Scotland[227]).

225 Lyons, *Interim Report and Consultation Paper* (2005), para 2.78

226 DWP, *Income Related Benefits: Estimates of Take-Up in 2003-04* (2006)

227 DWP, *Housing Benefit & Council Tax Benefit Quarterly Summary Statistics* (Feb. 2004)

11. Figure 15.3 shows that about 70% of non-pensioners who were eligible to receive Council Tax Benefit in 2003-04 but who did not receive it lay in the lowest quintile of income distribution. For pensioners, eligible non-recipients appeared to be higher up the income distribution: the equivalent figures being 56% before housing costs and 38% after housing costs. The difference between the two figures for pensioners can be explained by the fact that most pensioners were owner-occupiers, many of whom had paid off their mortgages. This suggests that DWP may be more successful at obtaining take-up from those pensioners with greatest needs than from those non-pensioners with greatest needs.

Figure 15.3: Position of eligible non-recipients in the income distribution (2003-04)[228]

	Before Housing Costs			After Housing Costs		
Quintile	1	2	3-5	1	2	3-5
Pensioners	56	33	10	38	43	18
Non-Pensioners	70	18	12	69	18	13

12. DWP figures indicate that take-up of Pension Credit (PC) is higher than take-up amongst pensioners of Council Tax Benefit. In 2004-05, take-up of PC was estimated to be 70-81% by caseload and 74-83% by expenditure.[229]

13. DWP has recently published qualitative research undertaken on its behalf by IFF Research Ltd into the barriers that exist to claiming PC.[230] The three primary barriers they identified were a belief among older people that they were not eligible to receive PC, a concern about how PC might interact with other benefits they were receiving and, to a lesser extent, a lack of awareness about PC. They also identified a number of secondary barriers, most of which surround the nature of the application process (e.g. unwillingness to disclose financial information, fear of submitting documents, fear of making mistakes in an application and a complicated application process). The researchers found that these factors discouraged older people from making "speculative" applications but most participants in the research indicated they would be prepared to go through the application process if they knew they would be eligible or at least felt they had a very good chance of being eligible.

228 DWP, *Income Related Benefits: Estimates of Take-Up in 2003-04* (2006)

229 DWP, *Pension Credit Estimates of Take-Up 2004-05* (2006)

230 DWP, *Understanding the Relationship Between the Barriers and Triggers to Claiming Pension Credit,* by Bunt, Adams and Leo, IFF Research Ltd, DWP Research Report 336 (2006)

14. Lengthy processing times can create hardship for claimants and their families in terms of cashflow difficulties. Eligible applicants receive support covering the period from the date of submitting their application, but nothing will be paid until the application process has been completed. Applicants may be pursued for council tax payment in the period until their application has been approved. Applications for both Council Tax Benefit and Housing Benefit are processed by local authorities. DWP has set target times for councils in processing claims, which are based on the top quarter of all performance figures reported to the Department by councils across the UK. These targets require new claims being processed within 36 days of receipt of the application, and notifications of changes of circumstances being processed within 9 days. The Accounts Commission report that in 2004-05, the average time taken to process new claims was 42 days. However, the Scotland-wide average hides wide variations across authorities, with times for processing initial claims ranged from 15 days in one council to 75 in another.[231]

15. We understand from COSLA that applications are often submitted in an incomplete or incorrect state. Although the clock for the performance indicator starts ticking as soon as the initial application is received, it can take some time before the application is in a fit state to be processed. Around 90% of fully and correctly completed applications are processed within 14 days. This suggests that much of the scope for reducing time taken to process claims lies in applications being as easy as possible for applicants to complete.

16. Making Council Tax Benefit easier to claim was popular with participants in the deliberative focus groups held by GfK NOP. Evidence we have received from DWP and COSLA, on behalf of local authorities in Scotland, suggests that several public and voluntary agencies are actively engaged in refining the application process to make if as easy as possible for claimants.

17. Since December 2005, The Pensions Service has operated a process for expediting the application process for claiming Council Tax Benefit amongst applicants for PC, taking advantage of the fact that eligibility criteria for pensioners of Council Tax Benefit are broadly similar to those for PC. Relevant information relating to recipients' PC award can be used directly in the processing of Council Tax Benefit applications. This has enabled DWP to reduce drastically the amount of separate information it requires of applicants for PC who also apply for Council Tax Benefit. As a result, the size of the claim form for these applicants is now three pages (as opposed to the standard model form which is over 30 pages in length).

18. The Pensions Service now completes application forms for three benefits (PC, Housing Benefit and Council Tax Benefit) over the telephone, saving applicants the burden of completing the forms themselves. A copy of the completed application form is sent to the applicant for review and signature. Where the Pension Service identifies a claimant who is unwilling or unable to use a telephone, they can arrange for home visits. A phone call might typically take 20 minutes, of which around 5 minutes would be devoted to completing the three-page application form for Council Tax Benefit.

231 Accounts Commission, *Performance Indicators 2004-05* (http://www.audit-scotland.gov.uk/performance/documents/2005profiles/servicespdf/BA.pdf)

19. We understand that COSLA and Help the Aged have recently been working on a revised Council Tax Benefit application form template for older people who are not eligible for PC. Furthermore, DWP and other agencies including Jobcentre Plus and HMRC have been developing measures to assist eligible non-recipients of working age to apply for Council Tax Benefit.

20. COSLA also inform us that local authorities will work with applicants to assist them in completing their application, insofar as budgets allow. This includes through telephone conversations and home visits, especially for those applicants who might find it difficult to complete the form.

21. These developments have been consistent with the objective of moving at least in the long term to an arrangement whereby those households entitled to receive Council Tax Benefit can be identified and receive the benefit automatically. In particular, the process of actively seeking out potentially eligible non-claimants can help to demonstrate that benefits are entitlements for those who are eligible, which they should claim. The measures have the potential to increase take-up levels among those non-recipients who have not been aware of the support available or who until now have been put off by the detailed application process. In relation to pensioners, it is possible that the process of combining the application process for Council Tax Benefit with that for PC, to which less stigma might be attached, may help to change the minds of many who until now have been reluctant to claim.

22. It is too early to know the effect of these initiatives. However, they do appear to focus directly on primary and secondary barriers to take-up of benefit (at least in the context of PC) which were identified in the recently published DWP research (see above) – improving awareness, simplifying the application process and, in particular, helping potentially eligible non-recipients to recognise that it is well worth their applying for the benefit. We support these initiatives, which can both reduce the time taken to process claims and improve overall take-up rates.

Increasing the savings limit

23. Entitlement to Council Tax Benefit is dependent upon both a household's income and any savings it may have. For this purpose, savings includes money in a bank, building society or post office account, money at home, National Savings Certificates, Premium Bonds, shares, bonds and investments. It also includes property and land, but not the household's main home. Any household with savings of £16,000 or more is not eligible for Council Tax Benefit, while a reduced award is payable for households that have more than £6,000 in savings.

24. The same savings thresholds apply to most of the personal benefit schemes – that is, Income Support, Job Seekers Allowance and Housing Benefit as well as Council Tax Benefit. A slightly modified version applies to recipients of PC, although again the annual reduction of entitlement amounts to around 10% of a household's savings over £6,000.

Table 15.4: Households by amount of savings and total weekly household income[232]

											Percentage of Households
	Total weekly household income										
Savings	**Less than £100**	**£100 but less than £200**	**£200 but less than £300**	**£300 but less than £400**	**£400 but less than £500**	**£500 but less than £600**	**£600 but less than £700**	**£700 but less than £800**	**£800 but less than £900**	**£900 but less than £1000**	**£1000 and above**	**All households**
No savings	44	44	39	32	29	23	20	15	13	16	9	27
Less than £16,000	46	47	49	53	55	60	60	65	64	62	56	56
£16,000 but less than £20,000	2	2	2	3	2	3	3	3	4	4	5	3
£20,000 or more	8	6	9	13	13	15	18	16	18	18	31	15

232 DWP, *Family Resources Survey 2004-05* (2006). Figures are shown as a proportion of each income band.

25. The lower savings limit was increased from £3,000 to £6,000 for people aged under 60 in April 2006 (the limit was already £6,000 for people aged 60 and over[234]). The higher threshold of £16,000 has remained unchanged since council tax was introduced in 1993. The UK Government recently stated that it has no plans to amend these limits further.[235]

26. Even with the tapering effect, the consequent marginal tax rate on low-income households in receipt of benefit is extremely high.

27. A number of local authorities, and professional bodies including the CIPFA Directors of Finance Section and the Institute of Revenues, Rating and Valuation (IRRV) argued in their submissions to us that the savings limits should be increased, removed altogether or at least reviewed. The fact that the upper savings threshold has not increased since 1993 adds weight to the argument that the savings limits should be increased.

28. However, it is important that this issue is kept in its proper perspective. As Figure 15.4 shows, the great majority of households in lower income bands (85-90%) have savings of less than £16,000 and so already lie below the upper threshold. To increase this threshold to £20,000 would only capture a further 2-3 percentage points of households. We accept there is a balance to be struck between taking account of savings and not penalising those who have the taken sound financial decision to put money away in savings.

29. The New Policy Institute in a report produced for Help the Aged (UK) argued that savings should be viewed in terms of the income that a household might expect to receive through interest, and that it was unfair for a household to be liable for full council tax by virtue of savings of, say, £16,000 which would be unlikely to earn more than £600 a year in interest.[236]

30. Savings should not necessarily be viewed purely in terms of the income they are capable of providing for the saver. We do not believe that taxpayers should be required to subsidise those households with substantial savings.

Rebranding Council Tax Benefit

31. A measure that should be considered to improve take-up rates would be to rebrand Council Tax Benefit as a Council Tax Rebate. The Layfield Committee referred to high take-up levels of assistance with domestic rates in the 1970s. About 85% of eligible households, and around 90% of pensioner households, received "rates rebates" then.[237] These are considerably higher than recent take-up rates for Council Tax Benefit. Being seen as a rebate rather than "assistance" might increase take-up of Council Tax Benefit.

32. We recommend that the Scottish Executive should pursue with DWP the possible effect that a rebranding of Council Tax Benefit from a benefit to a tax rebate could make in encouraging increased take-up.

234 In addition, no upper capital limit applies to those households receiving PC(GC), who are automatically eligible to receive full Council Tax Benefit (les any deductions for non-dependent members of the household).

235 House of Commons Hansard, Written Answers 64354 & 64355, 24 April 2006

236 New Policy Institute, *The Impact of Council Tax on Older People's Income* (2003)

237 Para 10.41

A supplementary benefit scheme for Scotland

33. The Northern Ireland Office plans to introduce a rate relief scheme as part of its reformed domestic rates system, to offer supplementary assistance for low-income households over what is available through Housing Benefit (Council Tax Benefit is not payable in Northern Ireland). This scheme will be self-funded from domestic rate income.

34. We sought legal advice about whether a scheme of local taxation rebates would be regarded as a social security scheme, which is a reserved matter. The advice we received makes a clear distinction between (i) a local tax which from the outset and inherently takes account of ability to pay and (ii) a local tax which initially does not take account of ability to pay, but which then uses a rebate scheme to adjust liability. The advice suggests that the Scottish Parliament probably have legislative powers to impose the former but not the latter.

IMPACT OF REFORMS TO COUNCIL TAX ON THE OPERATION OF THE BENEFIT SYSTEM AND ITS BUDGET

35. From discussions we have had with DWP officials, we are confident the reforms to domestic taxation we have considered are of a nature and extent that would not call into question eligibility to Council Tax Benefit under present regulations. The essential features of council tax – as a tax that is levied upon properties at rates that vary to a greater or lesser extent in line with their value – would remain unchanged.

36. Any reforms that make domestic taxation more progressive than it is at present by definition will reduce the amount of Council Tax Benefit that is paid because a more progressive system will reduce levels of payment required from households in the lower valued properties, who are most likely to receive Benefit. The regressivity of the present system results in Scotland receiving more Council Tax Benefit than it would under a more progressive system. Local authorities' total yield from local domestic taxation would remain unchanged with greater payments coming from households in higher valued properties.

Recommendation 8: We recommend that measures – including possibly rebranding the benefit as a tax rebate – to increase the take-up of Council Tax Benefit and its equivalent under LPT should be agreed and implemented as quickly as possible by DWP, the Scottish Executive and local authorities.

SECTION 16: PENSIONER HOUSEHOLDS

1. As a general principle, in designing the local property tax, one of our primary aims has been to address ability to pay. Consequently, we consider that no distinction should be made between the needs of low income pensioner households and those of other households on equally low incomes. However, we received many submissions from individuals and organisations representing older people, arguing that special arrangements should be made for pensioners.

2. The GfK NOP research revealed support for the idea that any reform of council tax should give pensioners "a fairer deal" than they presently receive. In their March 2005 report *Council Tax: A Path to Poverty?*, Help the Aged in Scotland proposed several reforms to the council tax system to assist older people in Scotland. Their focus was that no pensioner household should be required to pay more than 10% of their net income on local taxation; a situation they referred to as being in "council tax poverty", based on a definition of "fuel poverty" developed by the World Health Organisation to describe the circumstances of people who must spend 10% or more of their net income on fuel.

3. Help the Aged reported in a survey they commissioned that the average pensioner household in Scotland paid 11% of their net income on council tax and water and sewerage charges. They also referred to a case study where one 85 year old widow was found to be spending 27% of her net income on council tax and water and sewerage charges over the 10 month period in which she paid these. Their survey also found that the combined cost of council tax and water and sewerage rates usually represented the second biggest item of expenditure for pensioner households, behind food and ahead of such items as rent, heating and leisure.

4. The Help the Aged report and responses we received to our consultation demonstrate how significant a financial burden council tax can place on many low-income pensioner households. The debate about the impact of local taxation on these households has focused upon the following issues:

- The concept of "council tax poverty";
- Low take-up of a means-tested benefit;
- Calls for specific assistance for pensioner households;
- The fact that council tax bills have been rising faster than pensioners' incomes; and
- Particular problems for "asset rich, cash poor" pensioners.

The concept of "council tax poverty"

5. We consider the Help the Aged suggestion that pensioner households should not have to spend more than 10% of their net income on council tax to be somewhat arbitrary.. The central issue is to ensure as far as possible that households are not pushed into poverty as a result of having to meet their council tax obligations.

Low take-up levels of a means-tested benefit

6. This is a point that has been made forcibly to us by Help the Aged in Scotland (and to the Lyons Inquiry in England by Age Concern England). Help the Aged in Scotland reported that a recent survey they commissioned revealed two main barriers to claiming Council Tax Benefit.[238] One was a lack of awareness about the qualifying income level. The other was the complexity of the application process itself.

7. As we discuss in section 15 in relation to Council Tax Benefit, take-up rates among eligible pensioner households are lower than among the rest of the population. We are encouraged that the Pensions Service and other agencies have recently introduced pro-active measures to identify pensioner households that might be eligible to receive Council Tax Benefit, and to assist applicants in completing their applications. While it is too early to know the effects of these initiatives, we hope they can help to bring about the much needed improvement in take-up levels among pensioner households.

Calls for specific assistance for pensioner households

8. We have considered proposals that would give additional assistance to pensioner households, irrespective of their income or broader ability to pay. For instance, Help the Aged in Scotland proposed that single pensioner households should be given a 50% discount on their council tax and water rate bills as a matter of urgency. We also note recent reports that a Labour MSP has proposed that pensioner couples should automatically be given a 25% discount on their council tax bills,[239] and that the Scottish Conservative Party have proposed that pensioners should have their council tax bills halved.[240]

9. We consider that these proposals take no account of the ability to pay of pensioner households. The main focus should be on ensuring that households that are eligible for Council Tax Benefit receive it, rather than providing a universal discount that includes households that can afford to pay their due tax liability.

10. Pensioner households can be divided into three categories: those with low incomes and who receive Council Tax Benefit; those who are relatively or absolutely well-off, and those whose income or savings leave them above the benefit threshold but who nonetheless struggle to meet council tax bills.

11. The first category would receive little benefit either from a percentage reduction in their bill or from a flat grant, because their benefit would fall as their tax liability falls. The second category do not need assistance. It is only the third category who would really benefit from a blanket subvention. It is not economically efficient to provide assistance to the whole of a particular segment because a small percentage need assistance.

12. Universal discounts and rebates might be justifiable if pensioner incomes were intrinsically lower than for other adults. However, while median income for pensioner households is lower than for other households, pensioner incomes are in fact spread across the income distribution, as Figure 16.1 shows:

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238 Help the Aged in Scotland, *Council Tax: A Path to Poverty?* (2005)

239 *The Sunday Times* (July 2006)

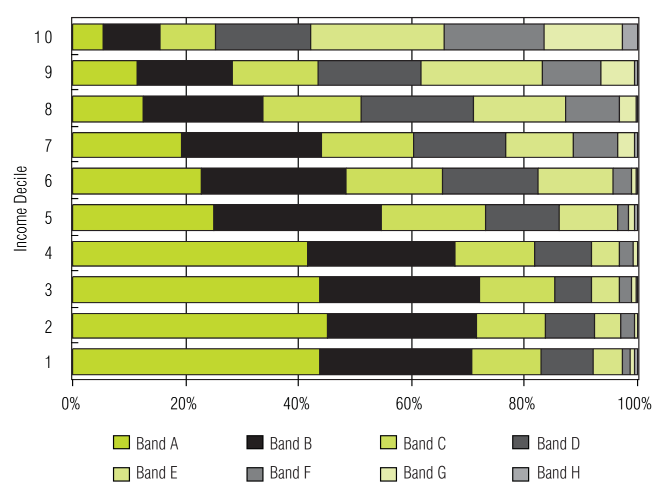
240 Scottish Conservatives, *Annabel Goldie at the Conservative Conference in Bournemouth,* Press Release (October 2006)

Figure 16.1: The Proportion of Individuals in Pensioner Families in Each Quintile of the Overall Population Net Income Distribution[241]

Quintile	Proportion of Individuals in Pensioner Families in Each Quintile *Before Housing Costs*	*After Housing Costs*
Top fifth	10%	13%
Next fifth	15%	18%
Middle fifth	21%	21%
Next fifth	29%	31%
Bottom fifth	25%	17%

13. A comparison of Figures 16.2 and 16.3, about the distribution of households by income and council tax band shows that low-income pensioner households (i.e. those up to income decile 5, other than those in income decile 1 which are most likely to be eligible to receive Council Tax Benefit) are not significantly more likely to live in an expensive home than other households.

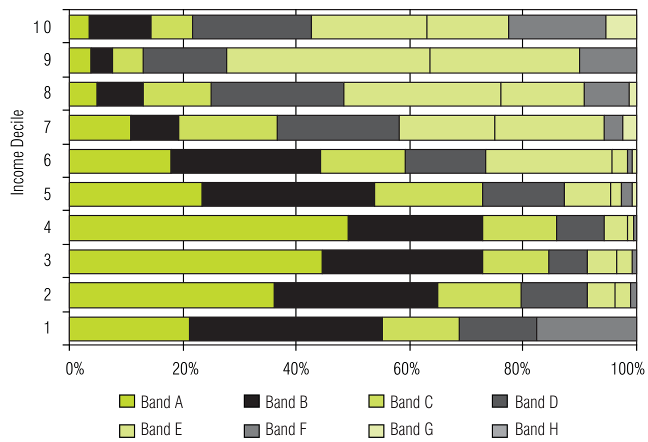
Figure 16.2: Distribution of All Households by Net Equivalised Income Decile and Council Tax Band[242]



241 Pensions Analysis Directorate, *The Pensioners' Incomes Series 2004-05*, based on data from the Family Resources Survey (2006). Results are based on equivalised income. Pensioners are defined as those adults in pensioner units where the head is over state pension age (including those below state pension age but living with a person over state pension age).

242 Sample data compiled by the University of Stirling from the Family Resources Survey

Figure 16.3: Distribution of Pensioner Households by Net Equivalised Income Decile and Council Tax Band[243]



14. As a matter of principle, we see no reason why a working-age household on any given income and living in any given house should be required to pay more local tax than a pensioner household on the same income and living in a comparable house.

15. Then there is the question of cost. Since almost one-third of households in Scotland comprise or include pensioners,[244] any self-funded scheme which assisted all pensioners irrespective of their income and wealth would place a significant additional burden on other households. For instance, a £100 net discount in council tax bills for all pensioner households would require an average increase of around £45 in council tax payable from other households, many of which would have less income and wealth than some of the pensioner households they were supporting.

16. The longer-term impact on the working age population of any measure introduced as a general rebate for pensioners would be even greater, as demographic changes in Scotland result in an increasing proportion of people of older people requiring to be supported by the rest of the population. In 2004, there were 3.3 people in Scotland of working age to every pensioner. Despite the forthcoming increase in the pension age for women to 65, that ratio is forecast to decrease to 3.0 to 1 in 2014 and 2.7 to 1 in 2024.[245]

243 Sample data compiled by the University of Stirling from the Family Resources Survey

244 *Census* (2001). In total, 31% of households in Scotland in 2001 either comprised or included pensioners Of these, 15 percentage points were single pensioner households and 8 percentage points were pensioner-only households with 2 or more people.

245 Government Actuary's Department, *Projected Population of Scotland (2004-Based)* (2005)

Council tax bills are rising faster than pensioners' incomes

17. Many pensioners who responded to our consultation complained that council tax bills are increasing faster than their incomes. To quote Age Concern Scotland:[246]

> "The steady increases in council tax have hit older people particularly hard, because most live on fixed incomes. State pensions rise broadly in line with prices, and many private pensions may not rise at all. In contrast, council tax has risen by more than the cost of living."

18. Council tax is a high-profile payment and we recognise that increases in these bills cause considerable and genuine concern to many pensioners. However, the inter-relationship between council tax and pensioners' incomes is more complex than this comparison suggests.

19. Council tax is only one of many items of expenditure that pensioner households, and other households, incur. From one year to the next, the effects of inflation mean that the cost of most of these items will increase.

20. The UK Government produces regular statistics which measure the rate of inflation. One of these measures, the Consumer Price Index (or CPI) is now the Government's preferred basis for measuring inflation for most purposes. Until 2003, the preferred measure had been the Retail Prices Index (or RPI). Both indices measure the difference in prices over a given period of time for a wide range of products and services that a typical household might spend money on. However, the CPI and RPI use slightly different shopping baskets to calculate inflation.

21. One key difference between the two indices is that RPI takes account of council tax bills, while CPI does not. The UK Government is presently committed to increasing the basic state pension by either RPI or 2.5% each year, whichever is higher. As a result, the increase in state pension takes account of the fact that council tax bills have risen faster than many other items of household expenditure.

22. Between 1996 and 2005, RPI increased by 25.7% and CPI by 15.3%.[247] In that time, the average council tax bill per dwelling in Scotland increased by significantly more than both figures: 57.0%.[248] However, this increase was more than reflected by the RPI, which took account of an increase of 87.0% in council taxes across the United Kingdom in this period. At the same time, some other items of expenditure that feature prominently in the basket of spending for a typical low income household increased by substantially less than RPI over this period (e.g. the cost of food rose by 8.8%) or even fell in price (the index for clothing fell by 20.1%).

246 Scottish Parliament Local Government and Finance Committee, *Paper LGT/S2/05/22/12: Council Tax and Older People – Evidence from Age Concern Scotland* (2005)

247 Office for National Statistics, *Focus on Consumer Price Indices February 2006* (2006)

248 Scottish Executive (http://www.scotland.gov.uk/Topics/Statistics/Browse/Local-Government-Finance/DatasetsCouncilTax); Comparison of figures for 1996-97 and 2005-06.

23. We are concerned that year-on-year increases in council tax bills should remain reasonable and affordable. Nevertheless, when a household's income is spent on a range of products and services, a comparison of changing incomes and spending must look at all items of expenditure, and not simply any one item in isolation.

24. As a further comparison of changes in the relative status of pensioner and non-pensioner households, we note that HM Treasury states that pensioners are now no more likely to be in relative poverty (i.e. below 60% of median income) than the population as a whole.[249]

Particular problems for "asset rich, income poor" pensioners

25. Some respondents expressed concern about the position of older people who have low incomes but who live in relatively expensive properties. In their submission to the Lyons Inquiry,[250] Age Concern England referred to some older people who many years ago have bought what was then an affordable property, but who now find the value of their property has increased disproportionately to their income.

26. It is important to place the incidence of "asset rich, income poor" pensioners in context. A recent study by the Joseph Rowntree Foundation[251] found that only around 200,000 pensioner households in Great Britain with low or modest incomes live in a Band F to H property, while some 3.9 million pensioner households with low or modest incomes live in a Band A to C property. Looking at pensioner and non-pensioner households together, the study concluded that:

> "Contrary to what is often considered to be the case, it can be seen that low income households are heavily concentrated in the lower valuation bands, and low income households in high value properties are exceptional."[252]

27. There is an economic argument that a local property tax such as we propose can be used to encourage optimum use of housing stock. We consider the arguments for and against this in section 9.

28. In relation to more vulnerable elderly people in particular, we recognise the argument made by Help the Aged (see section 9) that there are important links between an older person's home and their sense of well-being and their sense of identity. If they have the ability to choose their home based on their own priorities, this not only promotes their quality of life, it also has the potential to reduce the financial burden on the rest of society for social care costs associated with looking after an elderly person who may have lost informal support networks after moving to an unfamiliar new home. We have given thought to methods by which asset-rich, income poor pensioner households can meet the obligations of the new council tax.

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249 HM Treasury, *Budget 2006: Economic and Fiscal Strategy Report,* Chart 5.3 (2006)

250 ibid

251 Orton, *Struggling to Pay Council Tax: A New Perspective on the Debate About Local Taxation,* Joseph Rowntree Foundation (2006); the study defines low/modest incomes as incomes below median weekly gross household income.

252 ibid, page 13

29. Recent survey evidence[253] indicates that for many people the family home is not simply viewed as an asset which should be passed from one generation to the next. Two-thirds of those with the ability to leave a bequest say they will not worry too much about not passing on an asset, while more than half of the population say they are "not at all" or "not very" likely to inherit any property.

30. The results suggest that older people appear to be willing to use some of their lifetime assets rationally for themselves, to meet needs as they arise. A house is increasingly seen as a valuable investment for people to use in their own retirement, with older people frequently releasing equity from the value of their home during their own lifetime. Age Concern recently reported a rapid increase in interest in equity release among older people,[254] while Saga and Help the Aged both offer equity release products for older people. The scenario of an asset-rich, income-poor household described by Age Concern (see above) is one where a substantial proportion of the increase in value of the home – and therefore borrowing capacity – has risen through high levels of market demand. However, equity release schemes have a number of disadvantages, including the facts that they release a lump sum, which usually is larger than is required and they are expensive to set up. As these organisations acknowledge, neither equity release nor other kinds of borrowing are appropriate in all circumstances, and we recognise that particular care must be taken to protect vulnerable older people.

31. Pensioners who are asset rich but income poor may be eligible to receive Council Tax Benefit, which does not take account of the value of the family home. As stated above, Council Tax Benefit rules permit households to have up to £16,000 in savings, which covers 85-90% of households with modest incomes, and no capital limit applies at all to recipients of Pension Credit (Guaranteed Credit) (PC(GC)).[255]

32. For the relatively few low-income households with more than £16,000 in savings and who are not eligible to receive PC(GC), it may be reasonable to expect some of those savings to be used to supplement income.

Deferment of LPT liability

33. A particular problem arises for those relatively few pensioner households whose gross income is above the limit for any Council Tax Benefit support but who historically have lived in a relatively expensive house. The problem is caused by the impact of rising property tax on a relatively static income. So it is entirely feasible that some pensioner households might be facing a local property tax charge equal to 25-30% of their gross income, while still in receipt of an income above the limit of eligibility for any support. Removal of the single person's discount would worsen the situation.

34. We have considered whether it might be appropriate to introduce a tax deferment scheme for older people. Such schemes exist in other countries. We have discussed the suggestion briefly with COSLA and CIPFA Directors of Finance Section. Neither supports the idea. Nonetheless we are predisposed to favour any additional option that might help people to pay their local property tax.

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253 Joseph Rowntree Foundation, *Attitudes to Inheritance in Britain*, 2005

254 Age Concern, *Silver Surge of Interest in Equity Release*, Press Release (July 2006)

255 For the purposes of assessing eligibility to Pension Credit, the Pensions Service converts savings over £6,000 into assumed income at the rate of £1 a week for every £500 or part of £500 of savings.

35. There are several ways in which a deferment scheme could be implemented. On possible way is outlined in the following paragraphs. There may be one or more better options.

36. Under this proposal, local authorities would administer an optional local property tax deferral scheme for pensioner households who own their own homes.

37. There are a number of parameters which must be met, including:

- Any scheme must be simple and inexpensive for households to be able to apply for and for local authorities to administer;
- Local authorities' cash flow must not be adversely impacted – i.e. local authorities cannot be expected to finance the cash shortfall from financing deferments; and
- Local authorities cannot themselves borrow to fund the shortfall because of the potential impact on the Public Sector Borrowing Requirement. Consequently local authorities would act only as agents for the funders of the scheme and would have no liability under the scheme for any repayment of amounts deferred.

38. The scheme would be open to any homeowner without a mortgage or with sufficient residual equity. Whether eligibility should be limited to those over, say, the age of 65 is a political decision. The selected age limit must be high enough to ensure that the owner's (residual) equity in the house is sufficient to cover their actuarial life expectancy. In these circumstances, and given that the annual deferment would be less than 1% plus rolled-up interest, life expectancy should not be such for the debt and accumulated interest to exceed the residual value in the house, which value will increase over time. If this is considered a concern, then insurance cover should be obtainable with a one-off payment.

39. When qualifying householders receive the local property tax bill from their local authority, they would have the option each year of deferring payment. Whether they should be able to defer all or all except, say, £500 of the bill is for debate. Should they be required to make some contribution to the local authority's costs or not? Low income households in receipt of 100% Council Tax Benefit make no contribution to such costs and logically there is no reason why those deferring should not defer the whole amount.

40. The householder would inform the local authority of their intention to defer and send in documentary proof of their age(s). The local authority would then approve their application. The deferment would be funded through a new, special purpose company (SPC) with no other assets or liabilities, set up for any or all local authorities which are participating. Each annual deferment would be a separate amount in a SPC account in the name of the householder. So for example, after 5 years of deferments, the householder would have an account with SPC with five separate drawings and five varying amounts of compound interest. Interest would be charged by SPC but would be rolled up and added to the amount borrowed. So the householder would have no annual interest to pay.

41. The local authority would take a charge on the property concerned either in its own name or in the name of the SPC. If taken in the local authority's own name, the benefit of the charge would be assigned to the SPC. The cost of taking the charge would be added to the householder's deferment account with the SPC. As agent, the local authority would be responsible for ensuring that the householder(s) qualify, for taking the charge and for assigning the benefit of the charge to the SPC. For subsequent years, the householder would again seek a deferment and, because the structure already was in place, no additional work would be required, other than to inform the SPC of the amount involved.

42. Each annual deferment would constitute a separate loan. The SPC would have no employees and would be administered either by the local authority or by a private sector company. Its costs would be included in the interest charged to the householder's deferment account, which will be funded by further drawings on the funding lines.

43. The SPC would advance to the local authorities the amount deferred. It would fund itself from the market and would have no liabilities other than the funds it borrowed. It would be possible to borrow at a fixed rate for the expected period of each loan. There is a valuable precedent in the structure and methodology of the United States residential mortgage market where fixed rate loans are advanced for indeterminate periods.

44. When the house was sold, the local authority would release the charge on receipt of the amount in the householder's deferment account with the SPC and pass the funds to the SPC.

45. Although it sounds complex, the concept is one familiar to the financial markets and it would be easy to introduce. The local authorities would be responsible for confirming the value of the property (already done by definition for the purpose of setting the tax), for obtaining the first charge and for claiming the amount deferred by the householder(s). They also would be responsible for passing on the funds to the SPC on sale of the property. The SPC would be responsible for paying over the deferred amounts to the local authority, for maintaining the loan account records, for communicating with the householder and for funding itself from the financial market.

46. It is also worth considering whether such an optional scheme should be introduced as soon as possible, to enable eligible households to defer current council tax payments.

Recommendation 9: There is no valid justification for introducing any discount scheme covering all pensioner households irrespective of their income and we recommend that no such scheme be introduced.

Recommendation 10: Nonetheless, to address problems that face pensioner households that are relatively asset-rich and income-poor, we recommend that consideration should be given to the introduction of an optional deferment scheme for pensioner households who own their own homes.

Recommendation 11: We recommend that consideration be given to introducing an optional deferment scheme as soon as possible to enable eligible households to defer current council tax payments.

SECTION 17: NON-DOMESTIC TAXATION

BACKGROUND

1. Non-domestic rates are taxes on property payable by businesses in Scotland. Rate bills are calculated by multiplying an assessed rateable value for a business property by a non-domestic poundage rate. The rateable value of every property is determined by a local Assessor, who is independent of both local government and the Scottish Executive. The rateable value is the Assessor's estimate of the annual rent which that property would attract on the open market. A single national poundage rate applies across Scotland.

2. Non-domestic rates are normally paid by the occupier of a non-domestic property – usually this is the owner-occupier or tenant. If a property is empty, the owner or tenant may have to pay a reduced rate.

3. Non-domestic properties are properties such as shops, offices, warehouses and factories, and any others that are not classed as domestic properties. In some cases, properties may be used for both domestic and non-domestic use (for example, a Guest House or Hotel) in which case both council tax and non-domestic rates will be charged. It is the Assessor who determines the classification of properties (i.e. domestic or non-domestic).

4. Some types of property are exempt from entry in the Valuation Roll. This means that these properties are not liable to pay non-domestic rates. Some examples of exempt properties include:

- agricultural land and buildings;
- fish farms, fishing, and sporting rights;
- public parks;
- the sites of Automatic Telling Machines (ATMs) in designated rural areas; and
- churches and other places of worship (these are entered in the Valuation Roll but are fully exempt from rates).

5. In addition, business rate reliefs are available in a number of circumstances:

- Small Business Rates Relief is available for non-domestic properties with a rateable value of £11,500 or less. This relief provides a discount of between 5% and 50% on the rate poundage.
- Empty and unused properties are usually eligible for 50% rates relief, with no rates at all being payable for the first three months that the property is empty. For some properties (e.g. industrial and listed buildings, and properties with rateable values of less than £1700), no rates are payable at all. Local authorities also have discretion to apply rates relief where part of a property is completely unoccupied for a short time.
- Properties used wholly or mainly for charitable purposes attract rates relief of between 80-100%, where the occupier is a registered charity. Relief can also be provided at the discretion of the local authority to properties occupied by certain other types of non-profit-making organisation.
- Certain businesses in rural settlements qualify for rate relief of 50-100%, as do certain previously agricultural lands and buildings which are used for non-agricultural purposes. Discretionary rate relief is also available for stud farms.

6. Local authorities also have discretion to give up to 100% relief to businesses facing severe hardship in appropriate cases (for instance to businesses which are particularly important to the local community and where a one off assistance will resolve the difficulties).

7. Particular issues apply to certain types of business activity:

- Home workers: A person who works from home may be liable for non-domestic rates on the part of the property used for work, and will be liable for council tax for the rest of the property (the property's valuation band may change as a result).
- Holiday homes: These are liable for non-domestic rates if they are available for let for more than 140 days a year. Council tax is payable on any part of the property used as the occupier's home. Where a holiday home is available for let for fewer than 140 days per year, then council tax is payable instead.
- Bed and Breakfast homes: These are liable for non-domestic rates if B&B accommodation is provided for more than six people at any one time. In such cases, council tax also is payable on that part of the property used as the occupier's home. Where B&B accommodation is offered in the occupier's own home to six people (or fewer) and the occupier lives in the property, then non-domestic rates are not charged but. council tax is payable

THE OVERALL CONTRIBUTION OF NON-DOMESTIC RATES

8. Total non-domestic rate income in Scotland in 2004-05 was £1.812 billion. This compares with £1.960 billion gross council tax income. Non-domestic rate income increased by 36% between 1996-97 and 2004-05. In the same period, council tax income (including Council Tax Benefit) rose by 64%.[256]

9. Between 1996-97 and 2004-05, rateable values rose by 18%. The non-domestic rate poundage rate increased by 9%, from 44.9p to 48.8p. Following revaluation in 2005, the poundage rate in 2005-06 was 46.1p (up 3% on the 1996-97 rate but down 5% on the 2004-05 rate).[257]

10. The non-domestic rate poundage rate has been reduced again in 2006-07, to 44.9p. Occupiers of property with a rateable value in excess of £29,000 are required to pay a supplement on this rate of 0.4p in 2006-07 to cover the additional costs of the small business rate relief scheme.[258]

11. The in-year collection rate for non-domestic rates ranged in 2004-05 from 92.9% (West Dunbartonshire) to 98.8% (Orkney Islands). The Scotland average was 96.2%.[259]

256 Scottish Local Government Financial Statistics 2004-05, Tables S3, S4 & 11

257 Scottish Local Government Financial Statistics 2004-05, Table S4

258 Scottish Executive, *Non Domestic Rates Revaluation 2006-07 Transitional Arrangements,* 2006

259 Scottish Executive, calculated using local authority returns CTAS and CTAXBASE (http://www.scotland.gov.uk/Topics/Statistics/16945/CouncilTax).

12. Non-domestic rates account for a significant proportion of the overall tax revenue paid by businesses in Scotland. In 2003-04, estimated non-domestic rate income was £1.7 billion, and corporation tax revenue was £2.38 billion (excluding North Sea revenue).[260] In contrast, local taxes account for only around 8% of taxes paid by households.[261]

13. Businesses pay a greater proportion of their overall tax burden to local government than do private households. It is not obvious that the relative importance of local services is greater for businesses than it is for the public. For instance, responsibility for providing and maintaining the national infrastructure and business support on which businesses in Scotland depend tends to rest either with the Scottish Executive, the UK Government or even the European Union (e.g. in the case of support for agriculture and rural business). We have not attempted to quantify the extent to which different stakeholders benefit from services provided at either UK, Scottish or local level.

14. Any marginal change in the uniform business rate will make a significant difference to the overall tax burden that businesses pay. Any consideration of change to local business tax rates needs to take account of broader macro-economic effects as well as local issues.

ALTERNATIVE TYPES OF BUSINESS TAXATION

15. Responses to the public consultation suggested that there was little evidence of awareness of how non-domestic rates operate. Where views were offered, we have been struck by the limited nature of support for fundamental change in how businesses should be taxed. While there has been discontent about how much businesses in Scotland are expected to pay in tax, the non-domestic rates system itself is familiar and broadly trusted.

Tax on employment/payroll

16. Virtually no support for an employment tax or a tax on corporate profits was expressed by business representatives, local authorities or members of the public who responded to our consultation. It was considered that such a tax might discourage employment and could unfairly penalise labour-intensive businesses over their capital-intensive counterparts. To us, there appears to be little rational basis for considering this option further.

260 Scottish Executive, Government Expenditure and Revenue in Scotland 2003-04 (2005)

261 Based on an average UK household tax payment of £11,250 (source: Office for National Statistics, *Effects of Taxes and Benefits on Household Income 2004-05)* and average council tax per dwelling in 2004-05 of £887 in Scotland and £967 in England (sources: Scottish Executive and ODPM)

Tax on profits

17. We were surprised at how little support was expressed for a tax on business profits from the business community. We consider it arguable that many businesses, especially small or young enterprises, could welcome the removal of non-domestic rates as a fixed cost on their business that hampered their ability to become profitable. However, representative bodies argued that businesses work hard to make a profit and the last thing they then want is to find that profit being taxed. As Mervyn Rolfe of the Scottish Chambers of Commerce said in oral evidence to us about a tax on profits:

> "All of us in business want to make a profit. Even where someone has had a bad year this year, they still believe they are going to make a profit next year. You've got to, that's the only way you stay in business. So 'I'm going to be penalised as soon as I do make a profit' would be the attitude that they would come out with. I don't think you would find much favour at all."

18. Even the Federation of Small Businesses in Scotland, whose members might be most likely to benefit from the switch to a tax on corporate profits, preferred the status quo. To quote Susan Love in oral evidence to us:

> "The benefits of a tax on property are that it is a tangible asset, it's predictable you roughly know what the value is going to be, you roughly know what you are going to be paying and that's something that the members like, you know, they like the predictability of knowing roughly what they are going to be paying."

19. Similar comments about the importance of local taxation being predictable were made in a submission to us by the Scottish Retail Consortium.

20. Business representatives also referred to the potential administrative difficulties that might apply in operating a tax on profits. In particular, the question of transfer pricing bedevils tax calculations at all levels.

21. The potential difficulties and costs in collecting the tax were also referred to by some local authorities. Another concern was the fact that the yield from a tax on profits would be less predictable than the present non-domestic rates system. A tax on profits in principle should have an element of buoyancy.

Land value taxation

22. In our discussion about property tax options (see section 11), we considered the land value tax model. One of its potentially beneficial effects is in relation to vacant and derelict land.

23. In that respect, insofar as it aims to encourage appropriate development of medium- and large-scale parcels of under-utilised land, a land value tax is perhaps more obviously appropriate as a tax on business than on domestic households. The proposal for a business tax that was based on land value taxation was supported by the Scottish Green Party and by the Scottish Liberal Democrats, who suggested that it might be tested through a pilot. There is no reason why any property tax cannot be applied to vacant or derelict land to incentivise its optimal use.

24. RICS Scotland said that, while they agreed that tax models should be reassessed from time to time, changes to the existing system should only be taken where there are overwhelming reasons in terms of such factors as clarity, fairness and ease of collection.

25. We agree with the Scottish Liberal Democrats that the effects of a land value tax might be tested through pilot work before general implementation was considered.

26. We note the recent recommendation in the review of housing supply by Kate Barker for HM Treasury,[262] that a planning gain supplement should apply to landowners on the granting of planning permission, to capture for the community some of the gains that accrue.

27. HM Treasury has consulted on this recommendation and expects to report by the end of 2006.[263] We look forward to seeing the outcome of this consultation.

28. In relation to business taxation, non-domestic rates is a system which is clearly understood and broadly accepted by most non-domestic taxpayers. In the face of limited demand for change in a system which appears to work well, we do not recommend the replacement of the existing non-domestic rates system, although we would recommend giving authorities the power to tax vacant or derelict land and property.

LEVEL OF TAX

29. A number of submissions from business interests referred to the higher rate poundage that applies in Scotland, compared with that in England. In the report about the deliberative focus groups, GfK NOP also reported strong criticism by those paying business rates about the level of non-domestic rates.

30. However, this debate has since been overtaken by events following the First Minister's statement in September 2005 that the Scottish Executive proposes to bring the Scottish poundage in line with the English one as quickly as possible.[264] As indicated in section 7, COSLA did not press for re-localisation, taking the view that "having a uniform business rate is a sensible approach [to provide] a level playing field throughout Scotland".

31. We have not considered the future of the Small Business Rate Relief Scheme which was the subject of a recent separate evaluation undertaken by DTZ Pieda Consulting on behalf of the Scottish Executive[265]). Evidence there suggests that a negative relationship might apply between non-domestic rates and property rents.[266] Any decrease in no-domestic rates could be offset in whole or in part by an increase in commercial rent.

262 Barker, *Delivering Stability: Securing our Future Housing Needs,* HM Treasury (2004)

263 Hansard, Written Answers, Questions 69714 & 69716 (10 May 2006)

264 Scottish Parliament, *Official Report,* 6 September 2005

265 DTZ Pieda Consulting, *Evaluation of the Impact and Effectiveness of the Small Business Rates Relief Scheme* (2004)

266 e.g. Bond, Denny, Hall and McCluskey, *Who Pays Business Rates, Fiscal Studies* (1996); Institute of Fiscal Studies, *The Relationship Between Rent and Rates: An Analysis of the Relationship Between Non-Domestic Rates and Commercial Rents,* for the Department of Transport, Local Government and the Regions (1995)

OTHER PROPOSALS

32. A number of respondents have commented on the possible role of BIDs (Business Improvement Districts) and on the scope for encouraging local authorities to retain money flowing from rates buoyancy. In England, LABGI (Local Authority Business Growth Incentive) schemes have been introduced with that in mind. We have considered a proposal for a tax directed specifically at some or all of the tourism industry, with a view to raising revenue specifically for the tourism industry.

BIDs

33. A Business Improvement District (BID) is a precisely defined geographical area of a town, city, or commercial district, where businesses vote to invest collectively in local improvements resulting in improved economic performance. BIDs are developed, managed and paid for by the business sector by means of a compulsory BID levy on each business's non-domestic rates bill.

34. Before agreeing to fund the additional investment, the businesses themselves will decide how their money will be spent and how much they are prepared to pay. Each business liable to contribute to the BID will be able to vote on whether or not that BID goes ahead.

35. A BID can be established wherever additional services to those which the Local Authority provides are desired by the local business community. It could be located in a town centre, in one or two particular streets or an entire city centre area. Equally it could be located in an industrial estate, business park or even, if there is sufficient business support, in a sparsely populated area.

36. BIDs have operated with apparent success in England and abroad (notably the USA). For example, a BID in Union Square, New York City provides supplemental sanitation, graffiti removal, public safety and promotional services for the district. Another BID in Philadelphia has introduced successful maintenance, crime prevention and marketing projects.

37. In Scotland, we understand there is some support in principle for the concept in Scotland, based on responses to a 2003 consultation by the Scottish Executive,[267] provided there was a clear need for additional services and the benefits for businesses paying the BID levy were clearly identifiable. However, the Federation of Small Businesses in Scotland expressed concern that the scheme could turn into an expensive exercise that did not produce positive results for business. In oral evidence to us, they explained that, while BIDs should not duplicate baseline services, there exists nothing formal that explains exactly what benefits businesses should be entitled to receive as part of these baseline services.

38. The Executive is planning to implement BIDs nationally in April 2007. It is sponsoring a series of 6 pilot projects across Scotland in 2006-07.[268]

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267 Scottish Executive, *Business Improvement Districts – A Consultation Paper* (2003)

268 See http://www.scotland.gov.uk/Topics/Government/local-government/17999/BIDPilotprojects

39. The introduction of these schemes, if properly implemented, should provide an opportunity to bring specific benefits for local businesses and the broader community alike. BID schemes also might help to develop an ever more constructive and proactive relationship between councils and the business community.

Rates buoyancy and LABGIs

40. At present, the 3 year funding settlements for local authorities include in the annual totals estimates of income that each council will be expected to receive from non-domestic rates. In practice, the actual income that councils collect will vary year-on-year, not least as a result of changes in business conditions. Where actual non-domestic rate receipts fall short of the estimated income, the Executive meets the shortfall, supplementing local government income from the funding available to it. The corollary is that, where actual income exceeds estimated income, the Executive retains the surplus.

41. COSLA have argued that monies flowing from non-domestic rates buoyancy should be made available to councils – in other words, that local authorities should be able to retain non-domestic rates receipts where they exceed the estimated total. On a related issue, both Glasgow City and City of Edinburgh Councils have expressed criticism that they collect more non-domestic rate income than they receive from the non-domestic rate income pool. They suggested that local authorities should be able to retain a proportion of the growth in rates income.

42. The Government in England has recently introduced LABGI (Local Authority Business Growth Incentive) schemes, which enables local authorities to retain a share of additional non-domestic rate revenues they collect, as an incentive to stimulate local business growth. CBI Scotland and the Scottish Chambers of Commerce have expressed support in principle for a similar scheme in Scotland, while noting that there are complex issues.

43. We recognise the appeal of a LABGI scheme and that such a scheme could provide an incentive for councils to promote business and to improve non-domestic rate collection rates further. However, care would have to be taken to ensure that the benefits for local authorities arose from stimulating new business activity, and not from displacing existing business activity from other areas in Scotland.

44. We equally recognise the arguments that exist that cities in Scotland and overseas are the principal engines of economic growth and that a nation as a whole benefits when the economies of its major cities are healthy. The Scottish Executive already operates the Cities Growth Fund for the City-Regions in Scotland, currently worth around £40m per year, to support capital investment, to improve the urban infrastructure and to contribute to the regeneration of each city and City-Region. Although it takes the form of ring-fenced Executive funding, it appears to fulfil similar goals to those of LABGIs. We note that City-Regions are required to produce investment plans and to consult with neighbouring local authorities and other public and private sector stakeholders across each City-Region.

A tourism tax

45. City of Edinburgh Council put forward a strong argument in favour of an enabling power for local authorities to impose a levy on tourism-related businesses. They argued that council investment in their festivals held in August and December/January have helped to boost hotel occupancy rates. However, present non-domestic rates arrangements prevent local authorities which invest in tourist-related activities from benefiting from that investment, as the returns of any increases in the rateable values of visitor-orientated facilities that arise from increased tourism activity are channelled into the national non-domestic rate pool and redistributed across Scotland. City of Edinburgh Council proposed a discretionary power for local authorities, intended for use at times when visitor numbers – and council investment in tourism – are at their strongest.

46. A sample survey of enquiries we made to a number of hotels and guest houses in Edinburgh confirmed that prices quoted for August are often substantially higher than at other times of the year (in our sample, we compared prices for October). Many of the hotels belong to multi-national chains and it is questionable whether much of the proceeds from these mark-ups is retained within the local economy, or even within Scotland.

47. There is a question as to whether a local authority should be given a discretionary power to apply a tourism tax on accommodation or other tourist-orientated facilities in its area. We recognise the merits of the City of Edinburgh Council's argument and are minded to support the suggestion.

CONCLUSIONS

48. There are sound reasons for retaining non-domestic rates as the basis for local business taxation. Taxes on property are relatively inelastic, so the yield from non-domestic rates should be reasonably stable and predictable in the face of changing levels of business profitability or adjustments to tax rates. For businesses this has the disadvantage that their tax payment does not vary according to their ability to pay (i.e. their profitability). However, we were struck by the fact that business representative groups to whom we spoke considered that their members would prefer this situation to one where profits were subject to local taxation.

49. A uniform or similar rate of tax applying across the country can amplify differences in occupancy costs between high-cost and low-cost areas, providing a heightened incentive for firms to locate in low-cost areas.[269] This can be a valuable economic device for those parts of Scotland that face urban deprivation or rural isolation.

269 Maxwell and Vigor (eds), *Time for Land Value Tax?* (2005).

Recommendation 12: We recommend that non-domestic rates should be retained as the basis for local business taxation.

Recommendation 13: We recommend that the non-domestic rate should continue to be set by the Scottish Executive.

Recommendation 14: We recommend that non-domestic rates should be extended to vacant or derelict land, as an incentive for re-development.

Recommendation 15: We recommend that consideration should be given to introducing a discretionary power for local authorities to apply a tourism tax.

SECTION 18: FEES AND CHARGES

BACKGROUND

1. In addition to Revenue Support Grant support and income from council tax and non-domestic rates, local authorities receive substantial revenue from fees and charges. This includes payments for nursing and residential homes, school meals, sports facilities, operational policing, parking, trade waste collection and planning and economic development.

2. Councils can only charge for services if they have specific legal authority to do so and the presumption is that charges will be limited normally to full cost recovery. Thus for statutorily set fees (such as planning fees) and other charges that are not statutorily set but which are limited to full cost recovery (including liquor licences) there is at present generally little scope for increases beyond what is required to cover full costs. The ability to charge a market price, including a profit element, is limited to trading services, which might typically include sports centre charges and special uplift fees.

THE ROLE OF FEES AND CHARGES

3. In 2004-05, Scottish local authorities generated income from general services totalling £810.7 million from sales, fees and charges.[270] In addition to this, Councils receive rent income from tenants of local authority housing, but we are excluding this from our consideration as the costs and revenues of local authority housing are usually treated as a discrete and ring-fenced entity.

4. This income comes from a wide range of sources. Below is an illustrative list of examples of the types of charge that are levied, taken from responses we received from local authorities to questions we put to them about their charging policy in January 2005:[271]

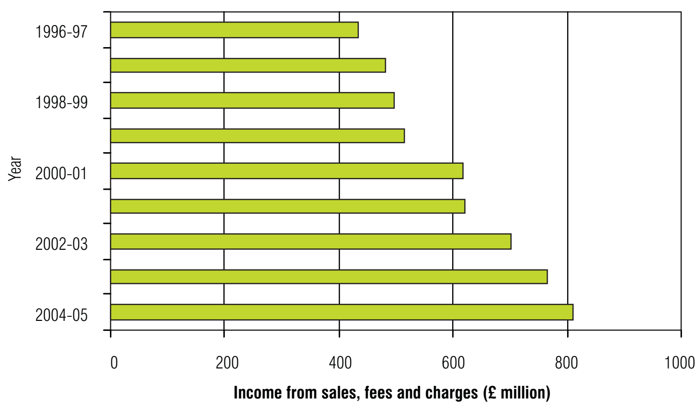
Social Work (£191.4m)	**Central Services (£120.2m)**
Accommodation (e.g. residential care, nursing homes, children's homes), respite care; day care for people with disabilities.	Licensing; birth, death and marriage certification; administration of Housing Benefit & Council Tax Benefit.
Planning & Economic Development (£108.6m)	**Education (£94.9m)**
Planning applications; building warrants; copies of plans from past consents; rental of business units.	School meals; adult education; music lessons; hire of school premises.
Roads & Transport (£94.0m)	**Environmental Services (£77.0m)**
Car parking charges; inspections of roads and streetworks; harbour fees & dues; cycle locker deposits.	Refuse collection (domestic & trade); charges to public conveniences; pest control; burial grounds.
Cultural Services (£74.3m)	**Police, Fire, etc (£50.4m)**
Sports ground and leisure centre use; hire of public halls & buildings; libraries; fees and sales from museums & galleries.	Crime, traffic and public order management; fire fighting and rescue.

270 Scottish Executive, *Scottish Local Government Finance Statistics 2004-05,* Table 2A (2006)

271 Income figures for each category are taken from Scottish Executive, *Scottish Local Government Finance Statistics 2004-05,* Table 4A (2006)

5. As Figure 18.1 below shows, income from sales, fees and charges has increased substantially in recent years: 87% between 1996-97 and 2004-05.

Figure 18.1: Local Government Income from Sales, Fees and Charges 1996-97 to 2004-05[272]



CHANGING THE LEVEL AND SCOPE OF FEES AND CHARGES

6. Around 60% of local government budgets are spent on education and social services. With the exception of some specific services (such as, in certain circumstances, residential care for the elderly and school transport and lunches), it is expected that these services should be free at the point of delivery. Other services, such a police and fire, road maintenance and street lighting, are provided for the benefit of the community as a whole and the extent to which any one resident gains from these services cannot be gauged or costed with any accuracy. This leaves two groups of local government activity: services over which local authorities already have discretion to levy fees, and services that are already subject to fees that are set by statute and which apply across Scotland.

7. The results of the statistical survey undertaken for us by MORI Scotland revealed some support for a closer connection to be made between what people pay for local services and the extent of their use of public services. Of the reasons for dissatisfaction with council tax, the third most frequently cited reason (mentioned by 25% of respondents) was that it bears no relation to the services that people use.[273] However, we believe that the thrust of this sentiment was that council tax takes inadequate account of the number of people in a household. Against a backdrop where there appears to be strong public concern that local taxes should take account of ability to pay, we have little hard evidence that many members of the public would prefer that people should pay directly for the services they use.

272 Scottish Executive, *Scottish Local Government Finance Statistics*

273 The most frequently mentioned reasons were that council tax is too expensive (mentioned by 54% of respondents) and that it takes insufficient account of ability to pay (31%).

8. This inference is reinforced by the outcome of the qualitative research undertaken by GfK NOP research, which revealed strong public displeasure towards the idea of charging for council services. This was particularly true for services that were seen as "core", such as education, social work, police and fire. However, most participants expressed similar views in connection with services such as libraries and leisure centres. Participants were not satisfied that the extension of charging for services would result in improvements to the quality of services. Indeed, fears were expressed that the quality of council services could fall, especially if levels of funding from other sources declined. Other reasons given for opposing charging were that they would particularly affect the poorest members of society and children and that charges would discourage use of public services (especially of services such as libraries and leisure centres), with potential implications for people's education and health.

9. Likewise, most local authorities that commented on the issue believed there is little scope to increase in any meaningful way the size of the contribution that fees and charges makes towards local government revenue. In keeping with comments from the deliberative focus groups, several councils commented that in setting and revising fees they take great care in balancing the desire for revenue against maintaining demand for these services. In particular, they are concerned about the regressive nature of fees, which could undermine efforts to promote social inclusion and healthy living practices. COSLA noted that a number of services for which charges are presently levied are still subsidised by the local authority, so fees themselves contribute towards the cost of the service but do not fully fund it. For a local authority to charge leisure and recreational services at full cost would lead to significant price increases. The CIPFA in Scotland Directors of Finance Section similarly contended that local authorities have adequate power to charge for a wide range of services, a power recently enhanced by the Power of Well Being introduced by the Local Government in Scotland Act 2003.[274] They too pointed out that a balance had to be struck between raising income through fees and charges and not disadvantaging deprived communities.

10. Turning to those fees, such as planning application and building warrant fees, which are set by statute for which local authorities have no ability to vary the fees, the CIPFA Directors of Finance Section proposed that these statutory controls should be removed, enabling councils to set whichever fee they wish. COSLA agreed that consideration could be given to the deregulation of some fees. However, they noted that such deregulation might result in pressure being put upon councils to reduce rather than increase some fees.

11. On the related question of whether fees and charges could and should be increased in order to allow local taxes to be reduced, feedback from the deliberative focus groups revealed a strong distrust as whether any such change would actually result in reductions in council tax payments. Likewise, several local authorities felt that the contribution that an increase in fees and charges could reasonably make to local government funding would be modest. COSLA argued in their submission that:

> "...if additional income can be generated for local authorities due to increases in the level or scope of fees and charges that this should be injected into developing and improving services not as a reason for reducing central grant funding".

274 Section 22(8) of the Act allows local authorities to impose reasonable charges for any action undertaken by the authority to promote or improve the well-being of an area and/or people in that area.

EXTENDING THE SCOPE OF FEES AND CHARGES

12. There is a separate question about whether we should consider recommendations about the potential benefits of fees and charges that could either fund new activities or promote desirable behaviours.

13. Our remit requires us to consider possible reforms to local government taxation, in the context of a series of criteria. While these criteria are numerous, they all relate either to ensuring that local taxes meet the key needs of taxpayers (e.g. ability to pay, accountability, dependency on the benefits system), or the key needs of councils (e.g. cost of collection, stability) or broader fiscal concerns of central government (e.g. balance of funding, effect on the economy). We have not been asked to consider any broader social, economic or environmental objectives.

14. We take the view that, while such proposals might well deserve further attention, we cannot ourselves give these proposals the necessary consideration within the scope of our remit. Furthermore we could not recommend any of these options purely on the terms of our remit.

15. For instance, we were invited by one MSP to consider a proposal to finance measures to tackle alcohol abuse through the imposition of a levy on the sale of alcohol in licensed premises. Such levies by their very nature do not contribute towards the general costs of local government services – they only finance the additional cost of these specific new measures. So, regardless of the merits of the proposal, we do not believe ourselves to be in a position to give it the necessary consideration.

16. There are taxes and charges that would contribute towards general local government revenues but which are also designed to promote positive behaviours. For instance, the suggestion has been made that householders should be charged according to the amount of refuse they produce, in order to encourage people to reduce household waste and recycle where possible.

17. The nature and size of the tax may be adjusted from time to time, to refine it more closely with emerging policy objectives. The more successful such taxes are at changing behaviour, the less effective they become in terms of raising money. Furthermore, the proceeds of such a tax would be volatile and difficult to predict with any degree of accuracy. The Committee recognise the benefits and attraction of such taxes and it is a matter of regret that they are unlikely to raise sufficient revenue to make a worthwhile contribution to core funding.

CONCLUSIONS

18. It is appropriate that some local authority services should be wholly or partially funded through fees and charges. We agree that local authorities should retain the existing discretionary powers they hold to set fees and charges for services in ways that do not undermine broader policy objectives.

19. We agree that a delicate balance has to be struck between, on the one hand, using fees as a source of revenue and, on the other hand, supporting broader policy objectives (such as promoting social inclusion and healthy living in the context of leisure facilities and minimising the inappropriate disposal of waste in the context of fees for environmental services). It is in our view appropriate that local authorities should have discretion over how, if at all, they choose to levy such fees. It is in keeping with that opportunity for discretion that there should be no expectation that local authorities will make a contribution towards their core funding from fees and charges for these services.

20. In relation to those fees which are set by statute and which local authorities have no ability to vary, we recognise the concern that deregulation might result in pressure being put upon councils to reduce rather than increase some fees. We take the view that, while it may be appropriate to conduct a debate as to whether these statutory controls should remain in force, there would be no significant benefit to be gained for the purposes of our review from the deregulation of these fees.

21. Overall, we agree with this broad consensus that fees and charges have a limited contribution to make to local government revenues. This was put eloquently by South Lanarkshire Council who, in their submission, stated:

> "… the impact of charging for a wider range of services would have a minimal effect on funds, and is not considered worthy of any in depth review."

SECTION 19: EQUALISATION

EQUALISATION OF RESOURCES

1. A central feature of the present local government finance system is the equalisation of each local authority's financial resources. There are wide variations in the size, demography and topography of the 32 authorities, ranging from, at one extreme, the 4 Cities and, at the other, small, sparsely populated rural areas such as the 3 Islands Councils. Without the equalisation of financial resources, many authorities would find it impossible to provide even a very basic level of services without putting an intolerable burden on local taxpayers.

2. The general principle of equalising public funding in the UK is long established and, so far as local government is concerned, now enshrined in Article 9.5 of the European Charter of Local Self-Government. Support for the principle was strongly endorsed by all of those – especially local authorities and other local government bodies – who commented on the matter in response to our Consultation Paper. We have, therefore, proceeded during the Review on the basis that equalisation of resources to protect financially weaker local authorities is a "given".

PROCESS OF EQUALISING RESOURCES

3. The equalisation of local authorities' financial resources is a 2 stage process which forms part of the procedure for distributing the total level of Aggregate External Finance (AEF) amongst the 32 local authorities. The first is to equalise differences in local authorities' assessed spending needs. This is done through the Grant Aided Expenditure (GAE) distribution system.

GRANT AIDED EXPENDITURE (GAE)

4. The relative spending needs of local authorities have for many years been assessed by what is known as the "client group approach". This allocates to each of the 32 authorities a share of Grant Aided Expenditure (GAE), the total of which, as well as its split between local services, is determined by Scottish Ministers as part of the overall local government finance settlement. The total of GAE represents Ministers' view of what authorities need to spend to provide services.

5. The "client group approach" is an objective method of calculating a relative GAE figure for local authorities which takes account of variations in the demand for services and the costs of providing them to a similar standard and with a similar degree of efficiency. The approach uses primary and, where appropriate, secondary indicators to assess demand and cost. Key to the validity of the process is the availability of objective data outwith the control of local authorities and which offer plausible explanations for inter-authority variations in the demand for and costs of providing services. In a small minority of cases, in the absence of any other data, budgeted or actual expenditure figures are used as indicators.

6. A range of indicators is used to assess relative demand for and costs of services. For example, the primary indicator for the Primary School Teachers GAE assessment is the number of primary school pupils in each local authority area, with a secondary indicator of the percentage of pupils in small rural schools. The sum of each authority's share of each of the service and sub-service GAEs determines an overall GAE figure for that authority that is then used in the equalisation process. Because it is distributing an aggregate level of GAE which has been pre-determined by Scottish Ministers, the system is self-financing. This means that there are "winners" and "losers" amongst authorities whenever any changes to the distribution formulae are made.

7. Any changes to the GAE distribution system are, in the first instance, considered by sub-groups of the joint Scottish Executive/Local Government Three Year Settlement Group, the membership of which comprises officials from the Scottish Executive, COSLA and individual local authorities. Changes to the system are subject to the approval of Scottish Ministers.

8. All the local authorities and local government organisations that responded to our consultation paper had something to say about the GAE distribution system. Many expressed more concern about ensuring that the overall size of the cake was adequate, that new burdens placed on local government were properly funded and that funds were not "ring fenced" than they did about how the cake was sliced up. Most of the responses referred in general terms to strengths and weaknesses of the distribution system. A number of local authorities expressed concern about particular aspects of it. For example, it was felt that insufficient account was taken of deprivation in both urban and rural areas. Two authorities – Aberdeenshire Council and Orkney Islands Council – made more detailed submissions about the system.

9. In its evidence to us, COSLA stated that there was a broad consensus amongst local authorities that the present formulae should be retained for the distribution of "core" Scottish Executive funding and emphasised the importance of maintaining stability in each authority's share of the cake. We were further told the Convention accepts that the present distribution formulae may not take full account of the impact on demand for and costs of services of deprivation and poverty, super-sparsity and diseconomies of scale, but argued that those issues could be addressed only once new monies to deal with them had been provided by the Executive.

10. Aberdeenshire Council raised both general concerns about the distribution system and a number of detailed points regarding particular GAE assessments. Orkney Islands Council expressed concern that its per capita level of funding was badly out of line with that of the other two Islands Councils. The Islands Council further argued that the whole distribution system increasingly lacks fairness and transparency, that it is in "serious need of overhaul" and that the process of distribution should be made independent of both the Scottish Executive and local government. When questioned about them, COSLA did not accept Orkney's general arguments. In particular, COSLA rejected the idea of making the distribution system independent of the Scottish Executive and local government, arguing that there was no need for a quango to undertake this function.

11. We note[275] that there is international precedent for decisions on the distribution of central government support for local government being made by independent bodies. Examples are the Inter-Government Commissions in Australia, Canada and the United States. In those countries, determination of the aggregate level of transfers from central to local government remains the responsibility of the central government. But the task of determining the formulae used for the allocation of the funds-concerned amongst local authorities is delegated to the Commission.

12. "The mechanism for distributing grant between authorities" is an "associated issue" in our remit and, as we think COSLA and individual local authorities – including Aberdeenshire and Orkney Islands Councils – appreciate, we have not been in a position to conduct a fundamental review of the GAE distribution system. Nonetheless, the fact that at least two councils have serious reservations about the present distribution suggest to us that the system as a whole needs to be kept under regular review. We recognise fully the desirability of stability in the distribution arrangements, especially now that three year budgeting has been introduced, but believe that a balance needs to be struck between, on one hand, stability in levels of funding and, on the other hand, ensuring that the system is kept under regular review to ensure that it remains as fair and objective as possible.

13. To assist this process and, on the basis of the international experience referred to above, we think that there might be a case for introducing an independent element into the GAE distribution system. One option could be a wholly independent body on the lines of those in Australia, Canada and the United States. Such a body would clearly have to consult local government on its proposals, especially having regard to the terms of Article 9.6 of the European Charter of Local Self Government. An alternative could be the appointment of some independent members to the existing Scottish Executive/Local Government Groups. We recommend that, in consultation with COSLA, Ministers should consider those possibilities.

EQUALISATION OF TAX BASE

14. The second stage of the process is to equalise differences in each authority's non-business tax base and consequently the ability to raise income from, at present, the council tax (the business tax base is now equalised through the pooling of non-domestic rate income and its distribution to authorities on a per capita basis). There are large differences in the number of properties subject to the council tax in each local authority area. For example, in 2004-05,[276] there were over 274,200 properties in Glasgow City and only 9,380 in the Orkney Islands. Properties in each area are spread across the 8 council tax bands, but, for ease of comparison, the numbers are converted mathematically to Band D equivalents.

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275 NERA Economic Consulting, *Options for Reforming Local Government Funding: A Report for the Lyons Inquiry Study Team* (2005)
276 Scottish Executive, *Scottish Local Government Financial Statistics 2004-05* (2006)

IMPLICATIONS FOR EQUALISATION OF TAX BASE OF ANY CHANGE IN LOCAL DOMESTIC TAXATION SYSTEM

15. We recognise that any change in the local domestic taxation system would have implications for the equalisation of each local authority's tax base. In purely arithmetic terms, this would be straight-forward in the case of our recommended local property tax. Instead of equalising differences in the number of Band D equivalents, tax bases would be equalised on the basis of differences in the total value of domestic properties – perhaps expressed as the product of a standard percentage tax rate – in each council area.

16. We further recognise that this could affect the stability of three year local government finance settlements. There are a number of possible ways of dealing with this. For example, local authorities might have to accept that updated tax bases would not be applied during the course of any three year settlement period. Alternatively, figures for years 2 and 3 could be less certain than at present or levels of support could be re-determined subsequently. How this is dealt with is something the Scottish Executive and local government would have to consider.

17. In the case of local income tax, equalisation of each authority's tax base would raise problems which could be difficult to overcome. Those problems would arise whether the local income tax rate was set nationally by Scottish Ministers or locally by each council.

18. The number of taxpayers in each area (even if information on this for the 32 Scottish councils could be supplied by HMRC) would not provide an appropriate basis for equalisation because of inter-local authority population movement and the fact that levels of taxable income can vary significantly from one taxpayer to another and from one tax year to another.

19. We consider that the basis for equalisation would have to be the local income tax yield in each council area. The use of historical tax yield data would have limitations because of the above factors. In any event, while HMRC issue historical tax yield data for a number of English local authority areas, they do not publish such data for Scottish (or Welsh) local authority areas because of the small sample size in many cases.[277]

277 See http://www.hmrc.gov.uk/stats/income_distribution/3_13_apr06.PDF

20. It would therefore be necessary to devise arrangements that allowed local income tax yield in each local authority area to be compared. Ideally this should be the actual yield for the year to which the equalisation relates. Because the self-employed do not have to submit their self-assessment returns to HMRC until 31 January following the end of the tax year in question, it could be year 3 before actual local income tax yield information for year 1 was available. The only way actual yield figures could be used to equalise each council's local income tax base would be to distribute AEF for year 1 initially using some sort of broad-brush proxy for tax yield (perhaps a standard percentage of the adult population), and in year 3, when actual tax yield information was available, to re-determine the distribution of AEF for year 1. Any such re-determination would produce "winners" and "losers" as compared with the original distribution. It would consequently introduce even more uncertainty and instability into the local government finance system as compared with the difficulty relating to regular revaluations under LPT which is discussed above and not only undermine but negate the benefits of three year settlements. Re-determinations of AEF would have to become a regular feature of the local government finance system if actual local income tax yield was to be the basis for equalising tax bases.

21. A possible alternative approach would be to operate a local income tax system in "shadow" form in years 1 and 2 – in other words, on a notional rather than actual basis – and then to use the tax yield figures for year 1 as the basis for equalising each councils tax base in year 3. Thereafter the local income tax system could actually be introduced and each council's tax base could be equalised using actual tax yield information for the most recent tax year for which it was available. But this possible alternative would involve placing a responsibility on employers operating the PAYE system and those subject to self-assessment to assess local income tax liability for years 1 and 2 on a purely notional basis. It might be difficult for them to accept that this burden was necessary simply to aid the distribution of AEF. And, of course, the notional local income tax yield figures would be historical data and subject to the limitations already outlined. Regular re-determinations of AEF could be avoided only if local authorities were prepared to accept a swings and roundabouts approach to the use of historical local income tax yield data for the purpose of equalising tax bases.

22. We think that, if a local income tax were introduced, a good deal of thought would have to be given to how the tax base of each local authority could be equalised for the purpose of distributing AEF. Another aspect of the difficulty of determining local income tax yield at an individual local authority level, is the problem authorities could face in preparing budgets and this is considered in Section 10.

23. In the case of any hybrid local taxation system, it would be necessary to take each of the component taxes into account in equalising authorities' tax bases. Any hybrid which had a local income tax component would give rise to the same difficulties which are discussed above.

POSSIBLE DEPARTURES FROM "FULL" EQUALISATION OF FINANCIAL RESOURCES

24. As indicated above, we believe that any departures from "full" equalisation of financial resources should be very much at the margin. But we consider that there might be a case for excluding any income raised from a tourist tax (which is considered in Section 17), especially if that income was used exclusively for tourism developments. We also believe that, if a Local Authority Business Growth Incentive (LAGBI) scheme (which is considered in section 17) was introduced in Scotland, there would be a case for excluding from the non-domestic rates income pooling arrangements any growth in rates income covered by such a scheme.

CONCLUSIONS

25. We believe that equalisation of financial resources must remain a central feature of the local government finance system, both to protect financially weaker local authorities and to avoid "post code lotteries" in the provision of essential services.

26. We further believe that any departures from "full" equalisation should be very much at the margin.

27. As regards GAE distribution, we believe that a balance needs to struck between stability and ensuring that the system is kept under regular review.

28. We recognise that any change in the local non-business taxation system would have implications for the equalisation of each council's tax base. In the case of our recommended LPT, equalisation should be relatively straight forward. But in the case of local income tax it could raise considerable problems.

Recommendation 16: We recommend that equalisation of financial resources remains as a central feature of the local government finance system. Any departures from "full" equalisation should be very much at the margin.

Recommendation 17: We recommend that, in consultation with COSLA, Ministers should consider the possibility of passing responsibility for the distribution system to an independent body or, alternatively, appointing independent members to the existing Scottish Executive/Local Government Committee which oversees the system.

SECTION 20: WATER AND SEWERAGE CHARGES

BACKGROUND

1. Responsibility for water and sewerage services across Scotland lies with Scottish Water. Responsibility used to lie with local government (at regional and island council level) until the Local Government (Scotland) Act 1994 transferred this to three new public water authorities: the East of Scotland Water Authority, the North of Scotland Water Authority and the West of Scotland Water Authority. The three authorities were subsumed into Scottish Water in 2002.

2. Despite these changes, responsibility for collecting water and waste charges has continued to lie with local authorities. The 32 councils in Scotland are required by statutory instrument (currently the Water Services Charges (Billing and Collection) (Scotland) Order 2006) to collect un-metered water and waste (sewerage) charges on behalf of Scottish Water. Local authorities then pass to Scottish Water a payment for water service charges received, less a set amount as a collection fee. In 2006-07 this collection fee is £4.86 per property in that council's area for which a water services charge is payable. We understand from Scottish Water that in total they pay around £13 million per year in collection fees to local authorities.

3. A direct relationship exists between charges for water and waste charges and council tax liability. Charges for water and waste charges for Band D properties are set for each financial year, and these charges are revised for properties in other bands in accordance with the same structure as applies to council tax (e.g. 6/9 for Band A; 18/9 for Band H) (see table X below). As with council tax, a discount applies to single person households with water and sewerage charges. Domestic properties which are not connected to the public sewer are not liable for the waste water charge.

Table X: Unmetered Household Charges 1 April 2006 to 31 March 2007[278]

Council Tax Band	**A**	**B**	**C**	**D**
Water	£111.00	£129.50	£148.00	£166.50
Waste	£125.40	£146.30	£167.20	£188.10
Combined	£236.40	£275.80	£315.20	£354.60
Council Tax Band	**E**	**F**	**G**	**H**
Water	£203.50	£240.50	£277.50	£333.00
Waste	£229.90	£271.70	£313.50	£376.20
Combined	£433.40	£512.20	£591.00	£709.20

278 Band D figures from Water Industry Commission for Scotland, *The Strategic Review of Charges 2006-10: The Final Determination* (2005)

4. Assistance with water services charges is available for households on low incomes. A permanent water services charges reduction scheme has operated since April 2006, replacing the previous transitional scheme. The scheme applies to households which are in receipt of Council Tax Benefit but who do not receive percentage reductions on their council tax (such as the single person's discount). Households in receipt of full Council Tax Benefit receive a 25% discount on their water services charge, while for other households the amount of reduction is proportionate to the amount of Council Tax Benefit received (e.g. a household receiving Council Tax Benefit to cover 50% of their council tax bill is eligible for a $12\frac{1}{2}$% discount on their water services charge).

ISSUES ARISING FROM OUR REVIEW

5. Our review has revealed several issues concerning the inter-relationship between local taxation and water and sewerage charges. These are:

- Failure to distinguish between council tax and water charge elements of "council tax bill";
- Rapid increase in water and sewerage rate bills;
- Limited assistance for those in need;
- "Council tax bills" only including water and sewerage charges;
- Enforcement of water and sewerage rate liabilities;
- Collection fees for local authorities; and
- Implications of our proposed local property tax.

6. We consider these in turn.

Failure to distinguish between council tax and water charge elements of "council tax bill"

7. Several local authorities argued in oral evidence that present billing arrangements, where council tax and water and sewerage charges appear on the one bill, causes confusion. In particular, they argued, many householders regard the amount they pay to their local authority as their council tax bill, and do not separately distinguish the water charge element from council tax itself.

8. In their submissions to us, several respondents to our consultation, who discussed their own council tax liability, either quoted or appeared to quote council tax bills in terms of both council tax and water and sewerage charge elements. Help the Aged in Scotland told us:

> "...there is a link between council tax and water rates and we know that the two are often seen by pensioners as being one bill. They are linked in terms of the fact they are set by the bands and that water rates obviously goes up every year at a much higher rate again than council tax and it is collected together. It is seen as being one tax…"

9. Scottish Water argue that water and waste charges are clearly set out in council tax bills, which are also accompanied by a discrete leaflet from Scottish Water. However, evidence suggests that – at the very least – water and sewerage charges are capable of being confused with council tax bills.

Rapid increase in water and sewerage rate bills

10. Water and sewerage charges have increased at a much faster rate than council tax levels in recent years. A recently published research report, commissioned by the Scottish Executive, stated that while council tax had increased by 22% in real terms between 1996-97 and 2004-05, water and sewerage charges had increased by 110%.[279] Several local authorities argued that, because many people fail to distinguish between council tax and water charge elements of their council tax bill, they attribute the full extent of the increase to rises in council tax itself.

Limited assistance for those in need

11. As mentioned above, assistance with water and sewerage charges is available to households on low incomes. However, this scheme, which offers maximum relief of 25%, is less generous than Council Tax Benefit, which provides most eligible households with a 100% rebate in their council tax bills.

12. However, it is important to place the restricted nature of this discount in context. The Scottish Executive issued a statement in February 2005 which set out the principles behind the new water charging regime, and the reasons for these principles.[280] That statement included a discussion about the proposed discount for low income households, which revealed that even this limited proposed discount attracted significant disagreement. Public research commissioned by the Scottish Executive on its proposals for water services revealed that, while many participants agreed with the objective of the proposed discount, about half of those questioned had reservations about the justification for such a discount.

"Council tax bills" only including water and sewerage charges

13. The fact maximum relief for water and sewerage charges is 25% of the bill creates a situation where many households, who are in receipt of 100% Council Tax Benefit, receive "council tax bills" that comprise only water and sewerage charges. Glasgow City Council stated in their written submission to us that over 25% of the bills they issue are to collect only water and sewerage charges. Across Scotland, some 400,000 "council tax bills" apparently only include water and sewerage charges. These are charges that local authorities must collect even though the households are not liable for council tax.

14. It is unclear what percentage of the shortfall in councils' collection of council tax actually relates to water and sewerage charges rather than to council tax itself.

279 Scottish Executive, I*mproving Council Tax Collection Rates in Scotland,* by Bramley, Karley, Rutherford & Wager, Heriot Watt University (2006)

280 Scottish Executive, *The Principles to be Applied in Charging for Public Water and Sewerage Services in Scotland 2006-2010*: *Statement by the Scottish Executive* (2005)

Enforcement of water and sewerage rate liabilities

15. Scottish Water have suggested that local authorities should apply more robust practices for collecting and recovering water and waste charges, working together with Scottish Water and the Scottish Executive. To quote their submission:

> "Scottish Water works with all 32 councils across Scotland and this has highlighted to us different approaches to billing, collection and recovery. A Scottish Executive sponsored benchmarking exercise to identify and encourage best practice may prove beneficial to improved billing and collection processes and levels."

16. In contrast to this position, Citizens Advice Scotland (CAS) are concerned about the powers that already apply to counter non-payment of water and waste charges. They argue that Scottish local authorities have stronger powers to recoup debts from the public than do utility companies, such as electricity and gas companies and Scottish Water itself. Because local authorities collect water and waste charges on behalf of Scottish Water, summary warrant procedures may be used against debtors of Scottish Water. CAS also claimed that local authorities, which are publicly accountable for the collection rates they achieve, tend to be more rigorous than private sector utilities in collecting debts, whose decisions about how far to pursue debts will tend to be strongly influenced by whether enforcement action is financially worthwhile.

Collection fees for local authorities

17. A large number of local authorities have argued in effect that the existing arrangements between Scottish Water and councils regarding the collection and remittance of water and waste charges are biased in favour of Scottish Water. In particular, COSLA and several local authorities have criticised the formula within secondary legislation[281] that determines the amount that councils are required to pass to Scottish Water as water and sewerage charges. This is calculated as total receipts received multiplied by the proportion of total payments due that are attributable to water and waste charges. So, for instance, if a local authority has an overall collection rate of 92% of council tax and water and waste charges due, then that council is required to pass to Scottish Water an amount representing 92% of the share of the total amount due that is attributable to water and waste charges, including where the council has collected less than 92% of the due amount. Where the local authority collects more than 92%, then it retains the surplus.

18. The criticism levelled by local authorities is that this formula inherently disadvantages them because, keeping to the example, it is more difficult to collect 92% of water and waste charges than 92% of council tax payments. Local authorities have to collect water and sewerage charges from all households, including those low income households in receipt of full Council Tax Benefit which are not liable for council tax and which may have the greatest difficulty in meeting the water charge liability. The formula takes no account of the additional costs associated in securing payment from such households, producing a cash-flow loss to the council which is required to pay Scottish Water for water and waste charges it has not yet received.

281 Currently the Water Services Charges (Billing and Collection) (Scotland) Order 2006

Implications of local property tax

19. We recognise that the introduction of the local property tax would give Scottish Water the option of levying water and sewerage charges on the basis of the value of domestic properties, with the added advantage of being more progressive than the current banding system.

RESOLVING THESE ISSUES

20. There is an inextricable link in our view between the issues set out above and the joint billing arrangements that apply to council tax and water charge bills. We believe these arrangements are inappropriate, as they provide scope for confusion as to how much households are expected to pay as a local tax for local services. In a period when water and charges have been increasing at a faster rate than council tax, this scope for confusion has resulted in local authorities being perceived to be responsible for rising bills which they collect but over which they have no control. Different support arrangements for low income households mean that households on full Council Tax Benefit are still liable for water charges, with ensuing collection cost implications for local authorities. Collection arrangements too cause scope for confusion, with collection powers reflecting the nature of the collector (local authorities) rather than the nature of the debt (a utility charge). In short, the existing arrangements do not make sufficiently clear that responsibility for water and sewerage services and charges rests with Scottish Water, and that the role of local authorities in relation to these charges is simply that of a collection agent for Scottish Water.

21. Perceived difficulties about water charge discounts for low income households have led to some local authorities arguing that water and sewerage charges should be brought within the scope of the Council Tax Benefit scheme. The Department of Work and Pensions, which is responsible for Council Tax Benefit, would have to agree to this. The proposal calls for a benefit payable across Great Britain to be extended in a way that would only benefit households in Scotland, and in respect of costs that are not associated with the responsibilities of local government today.

22. The extent of support for low income households towards their water charge bills is a matter for the Scottish Executive to determine. As far as the other issues listed above are concerned, the only way to resolve these in our view is to separate arrangements for collecting water and sewerage charges from council tax bills. Separate collection of water and waste charges would clarify the cost of these services to the public and the role of Scottish Water in providing them. It would also remove an element that hinders the accuracy of public perceptions about the role and cost of local government.

23. At a time when the Scottish Executive is encouraging the use of shared services, our conclusion may at first sight appear surprising. However, it is also questionable whether the existing system, in which the collection process is spelt out in secondary legislation, is itself conducive to efficiency. Removing the statutory obligation upon water charges to be collected alongside council tax bills would allow Scottish Water to investigate alternative collection methods that might be just as efficient, and possibly even more so.

24. Scottish Water already has a billing and collection function for, for example, business customers and domestic customers with a metered water supply. Alternatively, Scottish Water could commission an outside body or bodies to act as their billing and collection agents. There may be a role for local authorities to act as billing and collection agents for Scottish Water in future. As COSLA argued to us, this measure "would lead to an open process where local authorities and other organisations could tender for the contract to bill and collect for Scottish Water".

25. However, any future role for local authorities should be subject to a series of conditions. The first condition is that they should only undertake this role under a commercial arrangement and not as a statutory duty. Second, bills for water and sewerage charges should be issued entirely separately from council tax bills – in separate envelopes and preferably some time apart with separate payments being required. Finally, enforcement powers for water charge liabilities should reflect the nature of the debt and should not include the option of summary warrant procedures on the basis that the power is being used by a local authority. Even with all of these conditions, we have reservations about whether local authorities should have any continuing role in relation to the billing and collection of water charges in future, given the scope that would exist for continued confusion between water charges and council tax.

26. Scottish Water stated that the current annual cost of collecting water and sewerage charges is approximately £41 million (this includes provision for bad debt and the collection fees of around £13 million to local authorities). They have estimated that the annual cost of an alternative collection system that was either operated in-house or outsourced could ultimately be in the range of £32 million – £52 million.[282] They would have to undertake more detailed consideration to establish how collection rates and costs might change under different systems.

CONCLUSIONS

27. The present system, where local authorities are under a statutory responsibility to collect water and sewerage charges alongside council tax bills, is not transparent.

28. In keeping with principles of local accountability and good government, we believe it is appropriate that Scottish Water should assume responsibility for billing and collection of these charges, either directly or through another body or bodies under commercial arrangements. This work could be undertaken by local authorities, but subject to safeguards to make clear to households that responsibility for water and sewerage services lies with Scottish Water.

282 The lower end of this range assumes collection performance improving to a level currently being achieved in England and Wales; while the higher end of this range assumes collection performance as at today's rate.

29. For as long as council tax and water charge bills remain coupled, and local authorities remain under a statutory duty to collect water and waste charges, we consider:

- first that the payment formula should be revised in order to give greater allowance to councils in collecting water and sewerage charges from households that are on 100% or partial Council Tax Benefit; and
- second that local authorities should consider how they present billing information to their residents. Councils must distinguish more clearly in their literature the difference between council tax liability and water and sewerage charges.

Recommendation 18: We recommend that the statutory requirement upon local authorities to collect water and sewerage charges alongside council tax bills should be removed.

Recommendation 19: For as long as local authorities remain under a statutory duty to collect water and sewerage charges, action is required to improve the current system. We recommend that the formula for calculating collection payments to local authorities should be reviewed, to give greater allowance for the collection of charges from households in receipt of Council Tax Benefit. We also recommend that the council tax and water charge elements of the bill be distinguished more clearly.

SECTION 21: SUMMARY OF RECOMMENDATIONS

Section 5: The Role and Constitutional Position of Local Government in Scotland

Recommendation 1: It appears to us, from widespread evidence we have received from local government, that there is a corrosive argument about the relationship between central and local government. If this is so, then in order to resolve the argument, the Scottish Parliament, the Scottish Executive and the local authorities must grasp this nettle. Unless and until they do so, the underlying problems and consequent less than optimal structures will remain. The Committee cannot emphasise too strongly their recommendation that action must be taken quickly. *Transforming Public Services*[283] is both a welcome and necessary first step but a resolution must be achieved.

Section 10: A Local Income Tax

Recommendation 2: We recommend that a local income tax should not be introduced, either as a replacement for council tax or as a supplementary tax.

Section 12: Current Council Tax

Recommendation 3: We recommend that council tax should not be retained in its current form.

Section 14: A Local Property Tax

Recommendation 4: We recommend that a new Local Property Tax (LPT) should replace council tax. LPT would be assessed as a proportion of the capital value of homes in Scotland.

Recommendation 5: We recommend that the LPT should be payable with no discount for second and subsequent homes.

Recommendation 6: We recommend there should be regular statutory revaluations not less than every 5 years; ideally on an annual basis.

Recommendation 7: We recommend that all council taxpayers should be offered the option of paying LPT in 12 or 13 instalments and consideration should be given to making this option available under the council tax from 2007-08.

Section 15: Council Tax Benefit

Recommendation 8: We recommend that measures – including possibly rebranding the benefit as a tax rebate – to increase the take-up of Council Tax Benefit and its equivalent under LPT should be agreed and implemented as quickly as possible by DWP, the Scottish Executive and local authorities.

283 Scottish Executive, ibid

Section 16: Pensioner Households

Recommendation 9: There is no valid justification for introducing any discount scheme covering all pensioner households irrespective of their income and we recommend that no such scheme be introduced.

Recommendation 10: Nonetheless, to address problems that face pensioner households that are relatively asset-rich and income-poor, we recommend that consideration should be given to the introduction of an optional deferment scheme for pensioner households who own their own homes.

Recommendation 11: We recommend that consideration be given to introducing an optional deferment scheme as soon as possible to enable eligible households to defer current council tax payments.

Section 17: Business Taxation

Recommendation 12: We recommend that non-domestic rates should be retained as the basis for local business taxation.

Recommendation 13: We recommend that the non-domestic rate should continue to be set by the Scottish Executive.

Recommendation 14: We recommend that non-domestic rates should be extended to vacant or derelict land, as an incentive for re-development.

Recommendation 15: We recommend that consideration should be given to introducing a discretionary power for local authorities to apply a tourism tax.

Section 19: Equalisation

Recommendation 16: We recommend that equalisation of financial resources remains as a central feature of the local government finance system. Any departures from "full" equalisation should be very much at the margin.

Recommendation 17: We recommend that, in consultation with COSLA, Ministers should consider the possibility of passing responsibility for the distribution system to an independent body or, alternatively, appointing independent members to the existing Scottish Executive/Local Government Committee which oversees the system.

Section 20: Water and Sewerage Charges

Recommendation 18: We recommend that the statutory requirement upon local authorities to collect water and sewerage charges alongside council tax bills should be removed.

Recommendation 19: For as long as local authorities remain under a statutory duty to collect water and sewerage charges, action is required to improve the current system. We recommend that the formula for calculating collection payments to local authorities should be reviewed, to give greater allowance for the collection of charges from households in receipt of Council Tax Benefit. We also recommend that the council tax and water charge elements of the bill be distinguished more clearly.

ANNEX A

CALCULATION OF LAND VALUE TAX RATES REFERRED TO IN FIGURE 11.1

Figure 11.1 is an updated version of a table produced for the Committee by the Henry George Foundation. It estimates potential bills per household in 2006-07, were a land value tax in operation now.

The figures should be read with care. In particular:

a. House prices are still based on 1991 values;

b. Median values within each council tax band are used for the purposes of these calculations; and

c. Estimates for converting median capital values into median land values have been achieved through the use of land:building ratios provided to us by the Henry George Foundation. These ratios have been interpolated from a curve produced by the Foundation, with the assistance of someone they refer to as "a director of a national UK firm of surveyors specialising in land valuation". We have no evidence which either supports or challenges these ratios.

[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]
Council Tax Band	**Land:Building Ratio**	**Median Property Value (1991) (£)**	**Land Value Allocation (1991) (£)**	**Number Of Households (Sept. 2005) (000s)**	**Band Global Land Value (£m)**	**Band's % Of Total Land Value**	**Total Required From Band (£m)**	**Average LVT Bill**
A	25:75	20,000	5,000	536	2,680	6.2	136.0	**254**
B	34:66	31,000	10,540	562	5,923	13.6	298.3	**531**
C	38:62	40,000	15,200	362	5,502	12.7	278.6	**770**
D	40:60	51,500	20,600	283	5,830	13.4	293.9	**1,039**
E	42:58	69,000	28,900	291	8,410	19.4	425.6	**1,463**
F	44:56	93,000	40,900	154	6,299	14.5	318.1	**2,066**
G	46:54	159,000	73,190	100	7,319	16.9	370.7	**3,707**
H	50:50	265,000	130,250	11	1,433	3.3	72.4	**6,582**
TOTALS				2,299	43,396	100.0	2,193.6	

Explanation of Calculations for Table:

[2] Ratios on the average relative values of land and buildings within properties in each council, provided by the Henry George Foundation

[3] Median point within each band at 1991 values (assumptions made for bands A and H)

[4] [2] x [3]

[5] Number of households in each council tax band

[6] [4] x [5]

[7] The figure for each band in [6] as a percentage of the total for [6] (43,396)

[8] £2,194 million x [7]. £2,194 million is the estimated total council tax yield in 2006-07, calculated as the number of Band D equivalent properties in Scotland in September 2005 (1,942,933), multiplied by the Scotland average Band D council tax for 2006-07 (£1,129).

[9] [8] / [5]

GLOSSARY

Aggregate External Finance (or AEF)	Funding from the Scottish Executive to local authorities. AEF comprises revenue support grant, specific grants and non-domestic rate income.
Assessor	The person responsible for the valuation and revaluation of both domestic and non domestic properties within one or more local authority areas in Scotland.
CBI Scotland	The Scottish branch of the Confederation of British Industry (CBI), an organisation which represents the interests of UK business.
CIPFA in Scotland	The Scottish branch of the Chartered Institute of Public Finance and Accountancy (CIPFA), a professional accountancy body which specialises in the public sector.
Citizens Advice Scotland (or CAS)	An umbrella body which supports citizens advice bureaux in Scotland. These bureaux are independent local charities proving advice and information to people in need.
Commission on Local Government and the Scottish Parliament	Also known as the "McIntosh Commission". Chaired by Sir Neil McIntosh, this commission was established to consider the implications for local government in Scotland of the new Scottish Parliament. The Commission reported in 1999.
Comprehensive Spending Review (or CSR)	A periodic thorough review by Government of its expenditure and the objectives which this spending is intended to support.
Consumer Price Index (or CPI)	A measure of inflation. CPI excludes a number of items that are included in the Retail Price Index, mainly related to housing. These include council tax and certain owner-occupier housing costs (e.g. mortgage interest payments, house depreciation, buildings insurance).
Convention of Scottish Local Authorities (or COSLA)	The body which represents Scottish local government (COSLA also acts as the employers' association on behalf of all Scottish councils).
Deliberative focus groups	A type of public research. Small groups of people are invited to give spontaneous opinions on a subject. After being provided with further information, they are then invited to give informed views on the subject.

Department of Work and Pensions (or DWP)	A UK Government Department whose responsibilities include management of state benefits, including Council Tax Benefit.
Earned income	Income on the earnings of employed and self-employed people, including retirement and occupational pensions.
Equivalised Income	Household income adjusted for household structure. It is intended to capture the notion that households with more dependents are less affluent than households with fewer dependents even though they have the same income.
European Charter of Local Self-Government[1]	A document which establishes the basic principles of local self-government, to be applicable across Europe.
Family Resources Survey	A survey of households' circumstances produced by the Department of Work and Pensions.
FSB Scotland	The Scottish branch of the Federation of Small Businesses (FSB), an organisation which represents the interests of small- and medium-sizes enterprises in the UK.
Grant Aided Expenditure (or GAE)	An estimate by the Scottish Executive of local authorities' spending needs on local services.
Henry George Foundation	An independent economic and social justice think tank, which advocates land value taxation. It is named after a 19th-century American political economist.
GfK NOP	A research business, which conducted deliberative focus group work for the Committee.
Help the Aged in Scotland	The Scottish branch of a charity which provides services and support to older people and represents the interests of older people on matters of public policy.
HM Revenue and Customs (HMRC)	The UK Government department, which is responsible for collecting the bulk of tax revenue, as well as paying Tax Credits and Child Benefits. HMRC was formed in 2005 from the merger of the Inland Revenue and HM Customs and Excise.

1 Council of Europe, *European Charter of Local Self-Government* (1985)

International Monetary Fund	An international organization, established to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and in certain circumstances to provide temporary financial assistance to countries.
Institute of Chartered Accountants of Scotland (ICAS)	The professional body in Scotland for chartered accountants.
Institute of Revenue, Ratings and Valuation (IRRV)	A professional body operating in the field of revenues, benefits and valuation.
Jobcentre Plus	A UK Government agency (part of DWP) which supports people of working age from welfare into work, and helps employers to fill their vacancies.
Land value taxation (or LVT)	A type of tax, which is assessed according to the value of the land (excluding the value of any buildings upon the land). Also known as site value taxation.
Local government reorganisation	The term given to changes in local government structures. There have been two reorganisations in Scotland in recent times. In 1975, a two-tier local government structure was introduced, featuring 9 upper-tier Regional Councils, 53 lower-tier District Councils and 3 all-purpose Island Councils. These were replaced by the present 32 single-tier authorities in 1996.
Local Property Tax (or LPT)	The Committee's recommended system of local domestic taxation. See section 14.
Lyons Inquiry	An ongoing inquiry into local government finance and broader issues about the role and functions of local government in England, being undertaken by Sir Michael Lyons.
Macro-economics	An area of economic theory that examines the behaviour of the economy as a whole (e.g. effects on economic growth, prices and employment levels in a nation).
McIntosh Commission	See Commission on Local Government and the Scottish Parliament.
MORI	A research business, which conducted public survey work for the Committee. Now called Ipsos MORI.

Non-Domestic Rates	The form of local tax which applies to businesses in Scotland. Non-domestic rates are based on the rateable value of a business property.
Office of the Deputy Prime Minister (or ODPM)	A former Government department whose responsibilities included local government in England. Since earlier in 2006, these functions now rest with the new Department for Communities and Local Government.
Organisation for Economic Co-operation and Development (or OECD)	An international organisation which fosters good governance in public service, corporate and economic activity.
Pay As You Earn (or PAYE)	A method of collecting income tax on earned income. Employers deduct tax at source, before paying wages or salaries to their staff. They then send the tax on to HM Revenue and Customs.
Pension Service	The UK Government agency (part of DWP) which provides state financial support to pensioners.
Rateable value	The basis of valuation used in the past for domestic rates and today for non-domestic rates. The rateable value of a property is calculated as the notional rent at which it might reasonably be let in a free market.
Retail Price Index (or RPI)	A measure of inflation. RPI includes a number of items that are excluded from the Consumer Price Index, mainly related to housing. These include council tax and certain owner-occupier housing costs (e.g.mortgage interest payments, house depreciation, buildings insurance).
Revaluation	The process for updating property values.
Revenue Support Grant (or RSG)	A general grant payable as a contribution towards the cost of total general fund expenditure. RSG is part of Aggregate External Finance and the main form of Scottish Executive support to local authorities.
Joseph Rowntree Foundation	A UK social policy research and development charity.
Royal Institution of Chartered Surveyors in Scotland (RICS Scotland)	The Scottish branch of RICS, a professional body operating in the fields of land, property, construction and environmental issues.
Scotland White Paper	Another term for the document Scotland's Parliament, published in 1997, which set out the UK Government's proposals for a Scottish Parliament.

Scottish Assessors' Association (or SAA)	A professional organisation for assessors and their senior staff.
Scottish Budget	General funding from the UK Government to the Scottish Executive.
Scottish Chambers of Commerce	The umbrella organisation of chambers of commerce in Scotland, which represent and support member businesses locally.
Scottish Constitutional Convention	A body established to promote a parliament for Scotland and to develop detailed proposals concerning the establishment and operation of such a parliament.
Scottish Rural Property and Business Association (or SRPBA)	An organisation representing rural land and business interests.
Scottish Executive	The devolved government for Scotland, responsible for issues that lie within the powers of the Scottish Parliament.
Scottish Parliament	The devolved parliament for Scotland, with powers for matters including health, education, justice, rural affairs, and transport.
Scottish Variable Rate (or SVR)	A power of the Scottish Parliament to vary income tax. The power only applies to earned income at basic rate, and only allows tax at this rate to be varied either up or down from the UK income tax rate by up to 3 pence in the pound.
Scottish Water	The publicly owned water authority responsible for the provision of water supply and sewerage services in Scotland.
Self Assessment	The process by which liability to income tax not collected through PAYE is assessed. Under Self-Assessment, taxpayers are required to prepare a tax return, which then is used as the basis for calculating their tax liability to HMRC.
Site Value Taxation	An alternative name for land value taxation.
SOLACE Scotland	The Scottish Branch of the Society of Local Authority Chief Executives & Senior Managers (SOLACE), a representative body for senior managers in local government.

Specific Grants	Grants paid by the Scottish Executive to local authorities in Scotland as part of AEF. Unlike Revenue Support Grant, specific grants are linked to specific policy initiatives determined by the Scottish Executive.
Stamp Duty	A tax payable on the purchase of property or shares.
Unearned income	Income other than from earnings (which includes pensions from employment), including interest on savings, dividends on investments and rental income from property.
UNISON	A trade union, representing people working in public services.
Valuation Roll	A public document which contains an entry for non-domestic properties in an Assessor's area.

This document is also available on the LGFRC website:
www.localgovernmentfinancereview.org

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