



A Fairer Local Tax for Scotland:

A Joint Submission by:

**The Chartered Institute of Public
Finance & Accountancy (CIPFA)**

**CIPFA Directors of Finance
Section**

SOLACE Scotland

This is a joint submission by the following:

CIPFA, which is the leading professional accountancy body for the public services. It is responsible for the education and training of professional accountants and for their regulation through the setting and monitoring of professional standards. CIPFA is the leading independent commentator on managing and accounting for public money. The contribution from CIPFA has been prepared by the full-time officials of CIPFA and it has received the formal approval of the CIPFA Local Government Policy Panel on behalf of the Institute.

The CIPFA Local Government Directors of Finance Section is the professional forum which comprises the Section 95 Officers under the Local Government (Scotland) Act 1973 of all 32 local authorities in Scotland. The Section provides opinions on matters concerning the management and operation of Scottish local government finance and also serves as a learning forum for the exchange of experience and information on these issues.

SOLACE Scotland is the Scottish Branch of the Society of Local Authority Chief Executives and Senior Managers (UK) and has over 100 members. While being an important component of the UK framework, the Branch operates largely independently as the representative body for senior managers working within Scottish local government. The Society's members are drawn from a variety of backgrounds, and while engaging with all major players in Scottish governance at both local and national level, SOLACE Scotland has a unique role to play in offering a corporate view of local government.

Throughout the submission, references to "we" reflect the collective view of the aforementioned groups.

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Executive Summary

This submission sets out the collective comments of CIPFA, the CIPFA Directors of Finance Section and SOLACE Scotland.

As expert professionals working within local government, our role is to implement the policies of the government of the day. It is our duty therefore, to highlight the practical consequences of any proposed policy changes. In the spirit of objective engagement, we have identified a number of technical and legal matters which require to be addressed.

In our opinion the benefits of local government retaining its partial fiscal power, its responsibilities and its autonomy from central government have been both underestimated and overlooked.

We advocate a progressive property based system of local taxation, set and raised locally and based on a reformed council tax. We do consider however that there might be some merit in looking further at a combination of taxes to spread the burden of funding local government services.

Our strong recommendation is that further consultation requires to be undertaken once the Scottish Government can be clearer on the detailed issues raised within this submission, some of which include:

- our estimation that a funding gap of £742M would result from the proposed 3p local income tax rate. The solution to a shortfall in resources of this magnitude is not addressed in the consultation paper. The shortfall may require to be found within the Scottish Government budget meaning that the wider impact could extend beyond local government;
- our estimation that a local income tax rate of 4.5p would be required to maintain funding, and services, at 2008/9 levels;
- our assessment that the Concordat, which sets out the modern relationship between local government and central government, with its main message of removing burdens and bureaucracy may be compromised by a tax proposition which removes the partial fiscal autonomy of local government entirely; and
- the recognition that the proposal marks a fundamental shift in accountability and could result in tension with Article 9 of the European Charter of Local Self Government.

1. INTRODUCTION

Our Role and Responsibilities

- 1.1 As professionals working within local government, our role is to implement the policies of the government of the day. It is our duty, to highlight the practical consequences of such policy changes. The spirit of these comments is to ensure that we discharge our professional duty by working positively with government to ensure that the practical consequences of changing the tax base for local government are fully considered and addressed.

Our Approach To The Response

- 1.2 The consultation document has been clearly designed to have wide appeal, in particular to the general public. As a result, there is an absence of technical detail relating to the organisation and operation of the proposed nationally set local income tax.
- 1.3 Notwithstanding the absence of detail, and in the spirit of assistance, we have in this paper, attempted to indicate where significant gaps remain and also, to guide the Scottish Government on what further and fundamental questions of both a professional and policy nature remain to be asked or addressed. As a result we have not addressed the set specific questions included in the consultation document.
- 1.4 Proposals for what is significant reform of the financing of local government are worthy of detailed consideration and our strong recommendation is that further consultation is undertaken once the Scottish Government is able to be clearer on the technical issues raised within this response.
- 1.5 In developing our response, we considered it necessary to firstly set out the principles which any system of taxation should meet. We have then assessed the current proposals against these principles, identifying where the proposals meet and fail the principle tests. The proposals as they currently stand, are recognised by the government itself to result in a funding shortfall for local government services. We have undertaken our own assessment of the extent of the gap within this submission.

Technical Issues

- 1.6 There are a number of technical issues which would need to be addressed prior to the implementation of these proposals and we have set these out. We are not suggesting that the technical issues are insurmountable – we simply lay them out for government to indicate how they will be addressed. In addition, we pose a series of questions on legal matters in certain areas as well as identifying areas where existing legislation may require to be changed.

Financial Issues

- 1.7 We have where possible, provided estimates of the financial implications of the proposed policy change. We have not undertaken any separate analysis of any costs which may be associated with either, retention of the present system or any other model of local income tax. We would acknowledge that there will be costs associated with any diversion from the consultation proposal. We would anticipate however that as the policy develops, the financial memorandum accompanying the Bill will be a key document in setting out all associated revenue flows.
- 1.8 The current proposals represent the largest fundamental change since transition from domestic rates to the Community Charge. We recognise that the proposals under current consideration are significantly different to that method of taxation. However, it is vital that in potentially moving from one form of taxation to another that we do not allow a culture of non-payment or difficulty of enforcement to develop, as could be detected under the Community Charge. The non-payment culture reflected a lack of confidence in the system for a variety of reasons and eventually led to the demise of the tax and the creation of our current system of local taxation.
- 1.9 A further factor which has featured in previous considerations is the question about whether or not the raising of local taxation should continue to be confined to one single property based source. It could be argued that calls for changes to the taxation system in the past have generally arisen from a single tax source not being flexible or buoyant enough to fully absorb funding pressures leading to alleged excessive local tax increases and bringing to the fore claims of unfairness for some categories of taxpayers.
- 1.10 The financing model for local government has of course been the subject of many reviews and revisions over the life of local government. In particular the fiscal power of local government, which sets it apart from the rest of the public service, has attracted much debate. More recently debate focused upon whether property is a suitable proxy for wealth.
- 1.11 The Concordat, which sets out the modern relationship between local government and central government, and the resources available, signifies a new era for local government and its main message is one of removing burdens and bureaucracy and providing local government with more freedom. The concordat principle of freedoms and autonomy from central government micro management may be compromised by a tax proposition which removes the fiscal autonomy of local government entirely and instead will make it 100% funded by central government.
- 1.12 As a collective group, we believe that the benefits of local government retaining its partial fiscal power, its responsibilities and its autonomy from central government have been both underestimated and overlooked in the proposals. Consequently, we advocate a progressive property based system of local taxation, set and raised locally and based on a reformed council tax. We have appraised the current property tax system against the principles of taxation and indicate clearly where some reforms are needed.

- 1.13 However given the comments in paragraph 1.9 above we also consider that there could be merit in looking further at a combination of taxes to spread the burden of funding local government services.
- 1.14 Finally, given that the current policy direction is to be the pursuance of an income tax based regime, then, in the spirit of objective engagement we set out background details of an alternative model based on work undertaken by CIPFA some time ago. Based on that work, there is some evidence of a possible model in which a local income tax could supplement a property based system. A feature could be the retention of a property taxbase but with the realistic prospect of raising resources based on ability to pay

2. PRINCIPLES OF TAXATION

2.1 We consider that in the context of local government in Scotland, local taxation can be tested against each of the following principles:

- Accountability;
- Fairness;
- Stability and Predictability;
- Buoyancy of tax base;
- Ease of Understanding and transparency; and
- Ease of Collection including administration.

Accountability

2.2 In a democratic society the first requirement of any system of taxation is that 'the government, whether central or local, should be accountable to the electorate' for the tax which it raises. The relationship between local tax raising powers and democratically elected members has always been viewed as a strength of local authority accountability. Consideration of accountability in local government finance reviews (Layfield 1976, Burt 2006) some thirty years apart resulted in different conclusions on the relationship of local tax raising powers to accountability.

Fairness

2.3 There are at least three ways to consider fairness. Firstly, fairness between individuals, where those in similar circumstances should be treated alike and secondly, fairness between areas which takes account of varying needs and circumstances. Thirdly, the assessment of fairness will include the consideration of the wider basket of taxation which applies.

Stability and Predictability

2.4 Stability and predictability means that taxpayers, local authorities and the government should be able to rely on reasonably firm expectations about future commitments. Local authority services require predictability of income in order to set corporate and service plans and to set budgets accordingly. Individual taxpayers should reasonably expect to incur tax rates which do not fluctuate, other than marginally, between fiscal years.

Buoyancy of Tax Base

2.5 This criterion is generally considered to be the relationship of the tax yield to specific economic conditions. In a local tax this may be growth in levels of income or property valuations. Buoyancy while more likely to be evident in an income related tax, can also be detected in a property related tax.

Buoyancy will however be dependent upon the prevailing economic conditions.

Ease of Understanding and Transparency

- 2.6 An individual should be able to understand easily how their tax liability has been determined. If there is a related system of discounts, exemptions, personal allowances and other reliefs, this should not make it difficult to predict how much an individual has to pay.

Ease of Collection including administration

- 2.7 This principle is similar for both the taxpayer and tax collector. For both, the tax should be easily collected and easily paid. The design of the tax should make it difficult to evade payment and allow ready identification of those who have not paid.

3. APPRAISAL OF LIT AGAINST PRINCIPLES OF TAXATION

- 3.1 This section of our submission provides commentary on a number of technical issues which arise from consideration of each of the aforementioned principles as they apply to local income tax.

ACCOUNTABILITY

- 3.2 The relationship between local tax raising powers and democratically elected members has always been viewed as a strength of local authority accountability. If the rate of local income tax were to be set nationally, then it would be national government rather than local government which would have to be held accountable for the level of taxation and the resources available to local authorities.
- 3.3 This would also mark a fundamental shift in accountability. Local government would be held accountable for its expenditure on services. The proposed system, perhaps by design, breaks the present link in local government between local tax raising powers and democratically elected members.
- 3.4 A further consequence of a nationally set rate of LIT is that the role of Parliament itself in relation to local authorities will change. Because of the partial fiscal autonomy which local government currently enjoys, at present, the parliamentary subject committees consider local government matters but do not hold local authorities to account. That role is in effect held by the electorate. If local government lost this fiscal autonomy, they would become 100% grant funded and therefore more comparable with NHS Boards in terms of funding.
- 3.5 NHS Boards, as a consequence of the recent Local Healthcare Bill may eventually have elected representation. Wider policy direction would appear to result in a shift in emphasis of accountability from that of local taxation to direct election. It is not clear if consistency between local government and NHS bodies is an intended policy consequence. If intended, this would require separate and direct accountability arrangements to Parliament to be designed for local government.

FAIRNESS

The Tax Payer and the Rate of Tax

- 3.6 From the viewpoint of a taxpayer, a tax on income could be considered to be fair as it would acknowledge ability to pay. From an individual's point of view, the question of fairness may rest on the actual rate of income tax which they will have to pay. The proposal is however to tax earned income only. The consultation proposal omits unearned income from the tax. Fairness will therefore be impaired given that unearned income, which for some may be the main source of income would not be the subject of local tax.
- 3.7 At the moment the proposed rate is 3p. Individuals will assess the fairness of the tax when they know what the actual rate will be but will also assess it by the amount of their liability relative to that of others. The tax payers may reasonably assume however, that the level has been set at a rate which will maintain current services. It is our view that the rate of 3p is insufficient to maintain current levels of service. If it is the intention of Government to maintain services at current levels then either the rate will have to be increased or local authorities fully compensated through additional grant funding for the shortfall in resources .
- 3.8 Individuals will ultimately judge the fairness of the tax when both the required rate and consequences upon services are more transparent. We have estimated what those consequences will be at Section 4 of this submission. We note however that the consultation paper computes the impact on individuals but expresses the benefit, and consequent fairness, by household rather than by individual.

Current Exemptions from Council Tax

- 3.9 The consultation paper proposes a fairer tax and inevitably, this means that categories of individuals who are not currently liable for council tax will in fact fall to be liable for income tax. There may be a number of examples but two we would highlight are:
- Armed forces, resident in property in Scotland owned by the government; and
 - students
- 3.10 Properties held for forces accommodation are statutorily exempt from council tax. We understand that HM Ministry of Defence compensates local authorities with a broadly equivalent amount as a contribution in lieu of council tax. The abolition of council tax would of course result in the consequent abolition of these payments by HM Ministry of Defence. It is not clear if the loss of these amounts have been factored into projections. Armed forces personnel based in Scotland could however become potentially liable for income tax. Again it is not clear if any calculation has been factored in or if this is an unintended consequence.

- 3.11 Students in Scotland are presently statutorily exempt from council tax. For some, who will have earnings above the proposed personal allowance level, there will be a liability to pay local income tax beyond their requirement to pay income tax generally.
- 3.12 We make no comment on these policy intentions other than to seek assurance that this is intended and that the consequences of the income generated have been built into the calculations by the Scottish Government.

Distribution Methodology

- 3.13 The local government finance system is predicated on the basis of all Scottish local authorities providing a comparable level of service. Although each local authority has a different tax base, the allocation of grant from government is adjusted to reflect the actual tax base. Thus local authorities with high tax bases relative to others e.g. Edinburgh receive proportionately less government grant than those with lower tax bases e.g. Glasgow, because they can generate more income locally.
- 3.14 It is unclear from the consultation document, whether the principle of “comparable level of service” is to be maintained. If the principle is to be pursued, then it is unclear how it will be achieved, in particular how the local income tax will be distributed. Under the proposal for a nationally set tax, at least three questions can be asked:
- Will it be the case that income collected within a local authority area will be allocated directly to that local authority, or subject to pooling arrangements?;
 - What will happen to those local authorities which do not have a high tax base?; and
 - Will government continue to alter the grant which it issues to local authorities to reflect the actual income levels generated from the local income tax?

STABILITY & PREDICTABILITY

Cash flow

- 3.15 Of critical importance to the ongoing financial management of local authorities is cash flow. The consultation paper recognises (at paragraph 42) that council tax monies reflect a different and perhaps smoother profile than income tax. It should be noted however that any adverse fluctuation from the current profile will result in a direct cost to be borne by local authorities. That cost will arise from, as a minimum, additional interest payments and cash management charges.
- 3.16 By way of example on a case study basis:

Case Study

A large Scottish local authority has calculated that it commences collection immediately on 1st April and collects 95% of its council tax requirement by January of each financial year. For the purpose of cash flow under a local income tax, the local authority has assumed a delay of 2 months* in the transfer of resources from the Scottish Government to the local authority in the first year of the tax. The local authority will require to borrow short-term to enable stable service delivery during this period. The estimated cost of interest to the local authority; that is the additional resources required to fund cash flow, is of the order of £3M.

* 2 months understood to be minimum 'delay'.

- 3.17 We would stress that this estimated resource requirement will not result in the delivery of additional services but is the expected cash flow cost from changing the local taxation system.
- 3.18 An alternative to the local authority borrowing to fund the cash flow deficit would be for the Scottish Government to front-load grant payments to local authorities. However this would still incur costs and would require to be undertaken on a permanent basis so as to maintain cash flows to local authorities throughout each financial year.
- 3.19 A further risk to cash flow is of course the potential for non-payment. This submission highlights a collection rate in Scotland of approximately 98% for council tax. It is essential that the consequences of non-payment by individuals or the collection model adopted, will not result in adverse cash flow or reduced receipts.

Statement of Funding Policy

- 3.20 The Statement of Funding Policy sets out the financial relationship between HM Treasury and the devolved administrations. The latest version of the document (dated October 2007) states the following at paragraph 6.3:

“This statement is drafted on the assumption that current forms of local taxation continue”

- 3.21 We would consider that this statement determines that the funding policy in its entirety is predicated on the basis that the present council tax system remains in place. Any modification to that system could result in a review of the policy with an impact upon funding levels at a Scottish Government level.
- 3.22 The policy also makes it clear that there is a direct relationship with the Barnett Formula. Clearly, any wider United Kingdom consequences require to be investigated and clarified at an early stage before any further progress is made.

Other Matters

- 3.23 Further matters which the Scottish Government will require to fully investigate to ensure the stability and predictability of revenues flowing from the proposed local income tax include:
- the implications of any cross-border impact in which incentives may exist to enable tax avoidance with a consequent impact upon monies raised for local services; and
 - the impact arising from the timing consequences of the various means in which income tax can be paid.

BUOYANCY OF THE TAX BASE

3.24 Under current local government funding arrangements, the Section 95 Officer is reasonably certain of the income base to fund the cost of services. The local authority's income is presently composed of approximately 80% Government funding with approximately 20% raised from council tax. The Section 95 Officer is given an indication of the Government funding approximately three months prior to setting the budget. The local discretion over the rate of council tax also contributes to the certainty of the income base. Under a nationally set rate, the Section 95 Officer will not have the same certainty over the income base. There may be at least three theoretical ways for a local authority Section 95 Officer to manage the volatility of a local income tax:

- Diversification of other revenue sources;
- Application of budget setting and control techniques which may result in budgets being set on a more restrictive or conservative basis than as at present;
- Build and maintain reserves;

3.25 Alternatively, government could carry the risk (and the reward) of the volatility. This is currently reflected in the system of non-domestic rate, the tax charged on business. The rate of tax is set nationally by Scottish government although it is collected locally. Proceeds are placed into a central pool and redistributed back to local authorities based on assessed need. As part of the local government finance settlement local authorities are notified of their share from the non-domestic rate pool. It is government which carries the risk of economic downturn resulting in less money going into the pool than notified to local authorities as their share. The converse is true – where more resources are placed into the pool, that money is retained by government. The consultation paper gives no indication on whether the underwriting mechanism used within the NDRI system would be replicated for the local income tax system.

EASE OF UNDERSTANDING AND TRANSPARENCY

- 3.26 The nationally set rate would appear to be capable of being easily understood by taxpayers. Over time however the understanding that the tax is being raised for local resources will be eroded.

Capital Investment in Local Authorities

- 3.27 The Local Government in Scotland Act 2003 (the Act) replaced the old system of central prescription with a new local freedom in capital investment, under the broad title of the prudential framework. Responsibility for borrowing decisions, which funds much of local authority capital investment, is now based on the professional advice and judgement of the Section 95 Officer based on tests of affordability, sustainability and prudence. The freedoms arising from the Act, provided a local authority with the opportunity to propose council tax increases, the income from which, could be used to repay the borrowing on very specific capital projects. The highlighted case study below sets out the practical implications, the basis of which may be common across Scotland, currently as well as going forward. Clearly, this will require to be investigated to establish any national impact and to factor this into the Scottish Government's assessment of the implications of LIT on local authority spending.

Case Study

A local authority has entered into two Public Private Partnership (PPP) projects. Financing of the projects are, in part, based upon the increasing net annual unitary charges being met from council tax increases. The proposed nationally set Local Income Tax will not permit the local authority the flexibility to modify local taxation to meet this expenditure. Options open to the council are restricted to a review and reduction of other areas of expenditure to compensate.

Ease of Understanding and Transparency: Determination of Liability

- 3.28 We have detected initial technical issues in applying the proposal where a taxpayer is liable at higher rate and also has savings income. There are also difficulties for individuals who pay personal pension contributions or make Gift Aid donations as both of these are made net of basic rate tax. A question which will require to be addressed is whether, in relation to a Scottish taxpayer, net of basic rate tax is net of 20% or net of 23%. If it is the former, then an adjustment will be required to the taxpayer's tax bill and if the latter, extra money needs to be claimed by pension plans and charities in relation to Scottish taxpayers.

EASE OF COLLECTION INCLUDING ADMINISTRATION

- 3.29 The clearly stated preferred model for collection in the consultation paper is the use of HMRC. The consultation paper states that the Scottish Government “..will seek UK Government cooperation..” to use HMRC. It would appear reasonable, that, as a minimum, cooperation and the legal power therein, would have been sought in advance of consultation. The latest public record available to us would indicate that the Scottish government has not yet had discussions with HMRC on arrangements for collection of a local tax.

Impact upon HMRC

- 3.30 We understand that HMRC made preparations at the time of the Scotland Act. We further understand that for records of taxpayers set up under the PAYE system there is a Scottish Variable Rate signal, which is set up when a taxpayer moves to Scotland or, in the case of a person new to PAYE, the address is in Scotland.
- 3.31 Scotland has at present in excess of 2.5M individual taxpayers. Assessment and collection of a further tax will undoubtedly place burden on HMRC. The current capacity of the HMRC requires therefore to be rigorously tested at an early stage although we detect no evidence of this in the consultation paper.
- 3.32 The proposed model for collection of local income tax provides no estimate of costs other than to state, in referring to current local tax collection costs, that “..costs..would be considerably less than this”. The data and assumptions which support this assertion should be made available.
- 3.33 There would however be initial set-up costs to be incurred by the HMRC followed by ongoing costs of collection. The Burt Committee based on a submission from CIPFA, estimated that the costs of collection by HMRC would be in the range of £12M to £26M annually.
- 3.34 Any future discussions with HMRC could usefully include representation from the Directors of Finance to ensure that all practical implications associated with the consultation proposals are fully explored.

Impact upon Employers

- 3.35 In addition there would be an administrative requirement placed upon Scottish employers, and employers of income tax payers who are resident in Scotland. This additional cost to business was estimated by Burt to be between £17M to £28M annually. Clearly, the administrative impact, in terms of cost, will spread across the private sector as well as the HMRC.

Impact upon Scottish Water

- 3.36 Local authorities do not only collect council tax but also the water and sewerage levies. Reference to this important matter however is limited within the consultation paper to recognition that "...a review of these arrangements.." is required. The Scottish Government will as a minimum, require to consider the following issues:
- Collection of water and sewerage is based on the existing infrastructure to bill and collect council tax monies. Collection of water levy is in effect an example of a shared service arrangement. Abolition of council tax, and consequently of the staffing and other infrastructure, would remove the ability of local authorities to engage in efficient collection;
 - Any 'savings' generated from the removal of local authorities will of course be replaced or even exceeded by a separate billing and collection mechanism operated by Scottish Water or by another agency. Given the property related nature of these levies, clearly it is unlikely that HMRC could undertake any role; and
 - A separate 'roll' will require to be maintained of properties upon which water and sewerage would be levies. This may require separate valuations staff and appropriate IT systems.
- 3.37 The direct consequence of course will be that any revised arrangements will place an additional administrative collection burden upon Scottish Water. Revised collection arrangements for what is a levy collected properly by property will inevitably have not only an initial investment cost but will have annual revenue collection consequences. The existing capacity of Scottish Water to collect this tax will require to be carefully considered.

Case Study

Collection of water charges is a service provided to Scottish Water. Removal of the requirement to collect water charges, would remove the requirement for the service provision by the local authority. The financial consequences associated with service withdrawal would be, a reduction in income of £404,000 for providing that service.

- 3.38 It is acknowledged that these considerations may be evident but in the absence of any other debate we consider it essential that these matters are resolved at an early stage as part of further development.

Tax on Second Homes

- 3.39 The consultation paper proposes that an equivalent amount should be collected in respect of second homes as currently collected through the council tax. It is proposed that the non-domestic rates system is used for this purpose. We understand that there may be no technical difficulty with transferring these properties into the valuation roll. However it would present a challenge to ensure that a similar amount of tax is paid. At present some properties can be classified for council tax and non-domestic rates depending on whether they are being used for short-term holiday lets or longer term lets.
- 3.40 In the non-domestic rating system, they are billed at a small fraction of the amount payable under council tax. The rates system would require fundamental amendment to ensure that a comparable amount was billable. Alternatively, second homes and long term empty homes could continue to be billed under council tax – council tax systems would continue to be operated in order to collect residual balances. This would however mean substantial continuing costs of administration and valuation for these properties.
- 3.41 It is however important to consider the consequences upon service delivery. On a case study basis, a local authority has quantified the impact from lost income on second homes exemplified as follows.

Case Study

A local authority generates in excess of £1m per annum from council tax on second homes. It also estimates that owners and residents of second homes, will generally be minimal consumers of local services. The local authority directs these receipts towards the provision of affordable housing. The local authority estimates that while the loss of this income will have no direct effect on council services, there will be an indirect effect on the ability of lower-paid and young families to secure owner-occupied housing. There may also be a disproportionate effort required to maintain a records and a collection system for tax on second homes.

Economic Impact

- 3.42 We would be interested to establish the extent, if any, to which the proposals within the consultation paper have considered the wider consequences for the economy and the public purse relating to likely job losses and the reduction in spending power particularly in remote and rural areas.

4. THE FUNDING GAP

4.1 Scotland's local authorities are required by statute to set a budget which ensures that adequate income resources will be available to meet the spending plans for the year. This is generally referred to as the balanced budget. Somewhat significantly the consultation paper states at paragraph 30 that:

"The amount raised through local income tax will not be identical to that raised through the council tax."

4.2 The consultation paper does not reveal what the difference will be between the current council tax yield and that projected under the proposed 3% rate. This is a fundamental omission from the consultation paper. Yield represents the income expected to be raised from local taxes. We have estimated what the difference is between the present yield and that under the proposed local income tax rate. That difference we will refer to as the funding gap. Additionally we have calculated what the national rate would require to be on a yield neutral basis.

4.3 We estimate that the proposed 3p local income tax rate applied to the 2008/9 budgetary requirement would result in a funding gap of £742M. The funding gap can be further analysed between that element which relates to the expected 'loss' of council tax benefit (or subsidy) and the shortfall in tax yield generally as follows:

Funding	£'000
Council Tax Benefit (Subsidy)	433,560
Yield Shortfall	308,610
Funding Gap	£742,170

4.4 It is important to appreciate that what this reveals is the shortfall in locally raised resources which would otherwise be utilised for local service delivery.

4.5 We have assumed that service level reduction or a loss in resources overall is not an objective of the consultation paper. We have therefore computed what the local income tax rate should in fact be to maintain the 2008/9 budget requirement. We estimate that a local income tax rate of 4.5p would in fact be required, some 50% greater than the proposed 3p rate.

- 4.6 Any system of taxation must be sustainable over the long term. Consideration needs to be given to the scale of the long term funding gap which would be created by introducing LIT. In order to establish this, we would have to take a long term view of the future costs of delivering services across local government. In simple terms, we would then have to project what the likely income of the population would be and then apply the LIT tax rate in order to establish the tax income which local authorities would subsequently receive.
- 4.7 A further complication in this projection of likely future income of the population of Scotland, is that income will vary for several reasons including the performance of the economy. Somewhat fundamentally, the elderly demographic indicates an aging population with a consequent shift over time from earned to unearned income for part of the population.
- 4.8 The shortfall in resources will require to be found elsewhere within the Scottish Government block expenditure budget. Crucially then, while this consultation addresses local income tax, the wider impact will extend beyond local government.
- 4.9 We also considered what the impact upon the proposals may be if the Scottish Variable Rate (SVR) was applied. The SVR, under the Scotland Act 1998 is restricted to variation of the basic rate of income tax only. The resulting effect is that less monies will be raised. If the SVR was applied, our calculations revealed an even greater estimated funding gap of approximately £1.3B.

5. APPRAISAL OF LIT AGAINST EXISTING LEGAL FRAMEWORK

- 5.1 We would like to draw attention to a number of legal issues which arise from the consultation.

Article 9

- 5.2 We have considered the European Charter of Local Self Government. Article 9 refers specifically to the financial resources of local authorities. It states that:

“Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate”.

- 5.3 Our understanding is that the article is an international obligation placed upon the United Kingdom by a Council of Europe treaty. Our interpretation of Article 9 is that local authorities should have the ability to set local taxes. In that this differs from the proposed centrally set local income tax we would seek confirmation that the Scottish Government is satisfied that the terms of Article 9 will have been fully researched and satisfied.

Local Government (Scotland) Act 1975

- 5.4 Paragraph 8 of Schedule 3 of the Local Government (Scotland) Act 1975 states that “..all money borrowed..shall be secured upon the whole funds, rates and revenues..” This has been interpreted as being any repayment of borrowing ‘first call’ on rates. Where there is no local ‘rate’ then it is no longer clear what the hierarchy of repayment will be. Exploration will be required of what modernisation to legislation is necessary.

Council Tax Benefit Subsidy

- 5.5 The consultation paper makes the case for retention of the benefit based on three grounds which includes the wording of the current Statement of Funding Policy and also on a matter of principle.

- 5.6 The administration of all benefits within the United Kingdom is governed by the Social Security Administration Act 1992. Part 1 paragraph 1 (1) addresses entitlement to benefit and states that:

“...no person shall be entitled to any benefit unless...he makes a claim for it...”

- 5.7 This sets the core basis for all benefit claims within the United Kingdom including claims for council tax benefit. Clearly, at the most basic level, this requires the submission of a claim for benefit and is a prerequisite to any further consideration of entitlement. Benefit itself is paid by each local authority to the individual claimant. It is the Income Related Benefits to Authorities Subsidy Order which under the 1992 Act determines the separate receipts by authorities and referred to as subsidy. A distinction therefore must be made between the benefit paid and the subsidy received by each local authority. Consequently, it is subsidy (not council tax benefit) which will be foregone by local authorities.

- 5.8 The primary legislation at present makes no provision for consideration for benefit related to an income tax. The absence of benefit clearly means there is no associated subsidy. We would therefore question the case made in the consultation paper at paragraphs 45 to 49 for retention and would advise that this matter be resolved at the earliest possible date.

Legal power to collect taxes

- 5.9 The legal competence of the HMRC in acting on behalf of the Scottish Government is worthy of consideration. This matter was specifically considered by the Burt Committee which concluded that;

“...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”

- 5.10 Without legislation, any arrangement would be voluntary and Burt further concluded that this would not be “a robust basis” to manage the collection of this important revenue source.

Local Government in Scotland Act 2003 (the Prudential Framework)

- 5.11 Section 35, paragraph 1 of the Act states the following:

“It is the duty of a local authority to determine and keep under review the maximum amount which it can afford to allocate to capital expenditure.

- 5.12 It must be understood that this is a statutory duty, the discharge of which, in part is delivered using the ability to raise local taxation. Without that opportunity any future ability would be restricted to ‘spend to save’ initiatives. With the proposed introduction of local income tax, this local control (and means of accountability) will be removed. The practical consequences are this:

- that there is the risk of an inadvertent breach of Section 35 of the Act by the Section 95 Officer who in requiring to adhere to Section 35 is also required set a balanced budget as referred to in section 4 and at para 5.13 of this submission; and
- that a local authority would no longer have the ability to raise local resources to set a forward capital investment plan based on the service needs of the locality.

Setting a Balanced budget

- 5.13 Scotland's local authorities are required statutorily to set a budget which ensures that adequate resources will be available to meet the spending plans for the year. This is generally referred to as the balanced budget, as referred to at Section 4, and in itself is a cornerstone of local government finance and one of the many facets, which distinguishes local government finance from the private sector. A centrally set local income tax rate, set at a level which will not raise funds adequate for services, is contrary to the balanced budget concept and is a departure from what is a key legal responsibility of a Section 95 officer.

6. LOCAL PROPERTY BASED TAXATION – THE PREFERRED OPTION

6.1 One of the main arguments against the council tax is its regressive characteristics, in particular that it is not linked to ability to pay and therefore, impacts adversely upon fairness. We consider that it is entirely appropriate that a proportion of the local tax raising capacity in Scotland should be based on a progressive property tax or taxes levied on the 2.2M chargeable dwellings in Scotland.

6.2 The rationale for our support for a progressive property tax is based on the following appraisal of a progressive property tax against some of the key principles highlighted earlier in this submission. In conducting this appraisal we identify some of the reforms which could be undertaken to the present system

Accountability

6.3 A local property tax, set by each local authority is consistent with Article 9 and ensures the local link between elected members and local tax raising powers. The part property and part personal based nature of the present tax could be objectively examined to consider how the present reliefs and discounts could be more closely related to the property base than to personal circumstances.

Fairness

6.4 The prescribed and relatively narrow relationship between Band H and Band A maintains the regressive nature of the tax. There is a strong case for expansion of the number of bands and reconsidering the extent of the relationship between the highest and lowest band. Burt considered that property was a reasonable proxy for the wealth of an individual. These two competing views are linked by a benefit system which introduces ability to pay at a later stage in the system. In simple terms, the regressive nature of the tax is smoothed by the introduction of fairness at the point at which an individual pays the tax. Benefit reform however could be undertaken to simplify the relationship between the present council tax benefit system and the system of discounts and reliefs which are at present part of two separate legislative regimes. We consider that the recommendations made by Sir Michael Lyons arising from the 'Lyons Inquiry into Local Government' merit consideration.

Stability and Predictability

6.5 The stable nature of the tax base, the number of properties, enables a local authority to set an accurate local tax designed to raise resources to meet local need.

Buoyancy

- 6.6 There is some evidence of buoyancy within a property based system but without the volatility of income related taxation. Buoyancy, which for many, is a strength of a tax system would be supported by stability and predictability. Any risk of shortfall, a risk which would fall to the Scottish Government, could be discounted on the basis that a property tax base would provide the stable basis for continuation of local services.

Ease of Collection including Administration

- 6.7 Local authorities in Scotland collect council tax, at a level of approximately 98% of the expected level. Council tax is collected over time and for some local authorities the actual collection level is in excess of 99%. We consider that any tax which results in collection levels of this magnitude provides, in itself, a strong argument for retention and would maintain a link between local compulsory levy and local accountability. The tax base as well as non-collection is of course capable of being identified precisely with a fixed rather than a shifting tax base.
- 6.8 The estimated cost of council tax collection by Scotland's local authorities for 2007/8 was £35.697M. In addition, the cost of council tax valuation was estimated to be £11.27M. The estimated council tax yield for 2007/8 was £2.213B. The cost of collection as a percentage of tax yield was 1.6% (2.12% when valuation is included). The level of collection costs is reasonable at under 2%.
- 6.9 Although collection costs are not a material feature of the system, efficiencies may be available as the following case study reveals:

Case Study

7 councils located in the north of Scotland are jointly assessing the feasibility of a shared Council Tax/Benefits/Non-Domestic Rates service. The outcomes of the study, which is being funded by the Scottish Government, are due to be reported in October 2008 and may establish a pathway for substantial efficiency gains using a shared service model.

Ease of Understanding and Transparency

- 6.10 The property tax register is a matter of public record and taxation bills are provided statutorily on an annual basis. The tax bill is identifiable to a property.

6.11 There has been no revaluation of the council tax property base since 1991. Other professional property commentators will provide detail on the technical merit of revaluation. We consider however that the elapsed time alone since revaluation provides a robust reason for considering a current revaluation and for regular revaluations thereafter.

7. LOCAL INCOME TAX – A POSSIBLE MODEL

- 7.1 We have set out our preference for a property based system of taxation, it will of course be Scottish Ministers who decide, quite properly, on the final policy direction. Given however that the expressed preference of the Scottish Government is for a local income tax based system, in the spirit of solution, it may be helpful to be aware of work carried out by CIPFA for the Balance of Funding Review in 2004.
- 7.2 Based on that work, there is some evidence of a possible model in which a local income tax could supplement a property based system. A feature would be the retention of a property taxbase but with the realistic prospect of raising resources based on ability to pay.
- 7.3 The context must be clearly understood. The study was for a specific review, the conclusion of which was that a pan-UK system of local income tax was a feasible and practical option. For applicability to Scotland itself, a separate but significant study would require to be undertaken.

Key Features of the possible model

- 7.4 In summary the following characteristics would form part of the proposed model:
- Property tax set by individual local authorities (possibly a reformed council tax) is retained;
 - Local income tax set by individual local authorities to supplement property tax;
 - Local authorities could select a LIT from a range of rates while setting a precise property taxation yield to enable a balanced budget to be struck;
 - National personal income tax and RSG lowered in parallel; and
 - HMRC collect and remit the LIT to local authorities.
- 7.5 The estimated LIT taxbase could be based upon the Survey of Personal Incomes which inevitably represents the position a number of years earlier (e.g. for decisions to be made in October 2008 for the tax year 2009-10, the 2006-7 survey would need to be used).
- 7.6 We do not propose to set out all elements in this submission other than to state that, without advocating the system, we would accept the opportunity to explore with Government what the practical consequences of this possible model may be.