

Submission from Kenneth W McKay CBE
COMMISSION ON LOCAL TAX REFORM

1. Here are some thoughts on local domestic taxation that the Commission may find helpful.

Interest in Subject

2. I was Head of the Local Government Finance (LGF) Division in the former Scottish Office from 1989 to 1997. I took up that post soon after the birth of the Poll Tax and was there at its abolition and the introduction of the Council Tax. From 2004 to 2006, I was the Adviser to the Local Government Finance (LGF) Review Committee. I have taken an interest in LGF and local domestic taxation for over 25 years.

LGF Review Committee

3. This Committee was set up in June 2004 and stemmed from the coalition Agreement between the Scottish Labour Party and the Scottish Liberal Democrats which led to the 2003-2007 Scottish Government. The decision to establish the Committee was a means of dealing with the difference of view between the 2 Parties over the best form of local domestic taxation.

4. The Committee spent over 2 years examining LGF and, in particular all the possible local domestic taxation options, in great detail. The Committee's Report was issued in November 2006. It was - and in my view still is - a good Report. I would say that wouldn't I because I wrote chunks of it - but it is true, and I recommend that Commission Members read the Report. They might find it useful to also have a look at the report by Sir Michael Lyons who conducted a similar review South of the border around the same time.

5. It is a pity that the LGF Review Committee's Report was kicked into the long grass as soon as it was published, but, by the time it was issued, the 2007 Holyrood election was less than 6 months away and history demonstrates very clearly that local domestic taxation is a strong candidate for the "too difficult" box so far as political parties are concerned!

Council Tax (CT)

6. CT was introduced in 1993 to replace the Poll Tax (officially, of course, the Community Charge) which was abolished after John Major replaced Mrs Thatcher as Prime Minister and Michael Heseltine returned to Government as S of S for the Environment. The CT was very much a Conservative Party (rather than Civil Service) idea to deal with the toxic political issue of the Poll Tax. Unlike Domestic Rates (which preceded the Poll Tax), CT is not a pure property tax because it includes a personal element - namely, the 25 per cent single occupant discount. This discount was one of the features of the CT which was designed to appease Conservative MPs who were unhappy about the abolition of the Poll

7. CT is both a bad tax and an unfair tax. It is a bad tax because the banding system means that it includes the "slab" or "cliff-edge" feature which became discredited in the old Stamp Duty system. A small difference in the value of a property at a band edge can mean a difference of anything between £125 and £380 in CT payable. Those sums may seem small in relation to the "cliff-edge" impact of the old Stamp Duty system, but remember that, unlike Stamp Duty, they are annual amounts.

8. CT is also an unfair tax. First, it is - by design - a very regressive tax. The multiplier or ratio of 3:1 between the highest (Band H) and lowest (Band A) payments bears no relationship to the spread of either incomes or property values. This is to some extent mitigated by the CT Benefit Scheme which brings an income-related feature to the tax. The prolonged CT freeze has reinforced the regressive nature of the tax, making a bad situation worse. Secondly, all properties within each band in a local authority area pay the same tax. This unfairness is particularly pronounced at the bottom and top bands.

9. Increasing the multiplier or adding additional bands (at the bottom or top of the scale or both) or doing both has been suggested as ways to make CT fairer, but I do not think that that is the answer. Increasing the multiplier would exacerbate the "cliff-edge" effect, and more bands would create more "cliff-edges". It was those sort of considerations - having already reached the view that the best form of local domestic taxation was a property based tax - which led the LGF Review Committee to conclude that banding should be abolished in favour of individual property valuations.

10. A third CT unfairness arises from the fact that there has been no revaluation of properties or re-banding since the tax was introduced. As a result, those living in properties which have increased in value by less than the average are potentially being treated unfairly as compared with those whose properties have increased by more than the average.

11. I personally think that the single person discount is a fourth unfair aspect of CT.

12. CT is an "in your face" tax because local authorities issue one bill each year for the total amount payable (albeit that amount can be paid in instalments). The fact that the bill also includes Scottish Water's charges for water and sewerage exacerbates its impact. Research carried out for the LGF Review Committee suggested that many people thought that CT was both the largest and the most unpopular tax they paid each year. Income Tax and VAT were not seen in the same light, almost certainly because the former is "lost" in pay or salary deductions and the latter is paid in numerous individual transactions.

13. Although CT was initially reasonably well received as better than the Poll Tax, it is amazing that it has lasted unreformed for so long. This is almost certainly due to the "too difficult" factor mentioned above!

Property-Based Local Domestic Taxation

14. Part of the reason why local domestic taxation has been in the "too difficult" box is undoubtedly political unease about taxing property. Although we have had Stamp Duty (now replaced in Scotland by the Land and Buildings Transaction Tax) and Non-Domestic Rates for many years and some political parties have proposed a Mansion Tax, few politicians have, since the demise of Domestic Rates over 25 years ago, been prepared to advocate a return to a general property-based tax. Arguments against Domestic Rates and property-based taxation in general have included that tax liability should be based on income rather than the value of property occupied and the classic comparison between a widow living alone with 4 adults living next door which brought us the Poll Tax. There are in fact very few households consisting of 4 adults!

15. Although there is not a direct link between house values and income there is reasonable correlation. There is also a reasonable link between a "household" and the use of local government services, albeit that link is less strong following the removal of water and sewerage, police and fire services from local authority control.

16. My own view is that it would be a mistake to exclude taxing assets (of which property is most easily identifiable) from the "cocktail" of taxes. I also think that a straight property-based tax (that is, without a single person discount) could make a useful contribution to the efficient use of the national housing stock.

Property Revaluation

17. If the principle of property-based taxation is in the middle of the "too difficult" box, property revaluation is right at the bottom of the box. Some argue against revaluation in principle on the basis that householders should not be "penalised" for improving their property. But regular revaluation ought to be integral part of any property-based tax system. It is ridiculous that there has not been a revaluation since the CT was introduced and that a house built today would be banded on the basis of what it would have been worth in 1991. As indicated in paragraph 10 above, not having a revaluation does not have a neutral impact.

18. However, as revaluations produce winners (who keep quiet) and losers (who scream and shout), politicians tend to hold them as infrequently as possible or not at all. The longer the interval between revaluations, the greater the winners/losers problem. If a CT revaluation were held now there would clearly be large increases in property values given the movement in house prices over the past 24 years, and a redistribution of the tax burden (with those whose properties have increased in value by more than the average paying more and those whose properties have increased in value by less than the average paying less) but there is no need to increase the overall tax yield. However, I do not under-estimate the political problem of getting across a message that a revaluation would not necessarily increase overall yield.

19. Any property-based replacement of the CT - or indeed any reform of the CT - would require the revaluation nettle to be grasped. Although politicians would shudder at the thought, I think that the answer would be to have frequent revaluations and if possible to build automaticity into the tax system. Scottish Assessors told the LGF Review Committee that it would even be possible to have yearly revaluations using house price index data.

Non-Property-Based Local Taxation Options

20. Those options include Local Income Tax. (LIT); Local Sales Tax; and Land Value Tax (LVT).

LIT

21. The SNP and the Scottish Liberal Democrats both argue that the CT should be replaced by LIT. "Local"IT is a misnomer as no one has ever seriously suggested that the tax should be set and collected by local authorities.

22. As regards tax setting, both the SNP and the Scottish Lib Dems originally favoured a system under which each of the 32 Scottish local authorities would set its own LIT rate. However, the SNP proposed subsequently that the Scottish Government should set one rate which would apply to each local authority. The Scottish Socialist Party also proposed a form of LIT, called the Scottish Service Tax, but that tax was not a feasible option.

23. As regards tax collection, the only sensible way to collect LIT would be to piggy-back on the Income Tax system. In other words, to use the same personal allowance: tax bands: tax reliefs and the PAYE and Self-Assessment systems. Tax collected would then be passed by HMRC to local authorities either directly or via the Scottish Government.

24. In theory it would be possible to collect a different LIT rate for each local authority through the PAYE and Self Assessment systems, but this would complicate the former for all employers and especially those whose employees live in a number of different local authority areas. For example, a large employer in Edinburgh might have to collect different LIT rates for Edinburgh, East, Mid and West Lothian and Fife Councils. A nationally-set LIT rate which applied to all 32 local authorities would be easier to administer, but would still increase the burden on employers and in addition end the last vestige of local authority tax-setting and mean that all of councils' income (other than that from charges) was determined by the Scottish Government.

25. The SNP, the Scottish Lib Dems and others argue that LIT is the fairest local tax as it would be levied on income and consequently reflect directly ability to pay. It would be possible to apply LIT to only certain income - for example, that subject to the basic rate of Income Tax - but the tax would be fair only if it applied to all taxable income. And it would not be feasible to apply LIT to savings and dividend income (this income is not even being included in the devolution of Income Tax to the Scottish Parliament). This income constitutes only about 10% of total taxable income, but it would mean that some people - likely to be the better-off - would not make a fair contribution to the funding of local government services.

26. Would it really be fair to apply the same LIT rate to every local authority area irrespective of the quality of local services or the efficiency of the delivery of those services? And would it make economic sense to add LIT to Scottish Income Rates, especially given the possibility that, under the plans for further devolution to the Scottish Parliament, those rates could already be higher than Income Tax rates in the rest of the UK? And further would it make economic sense to remove an annual property-based tax from the cocktail of taxes?

27. The devolution of Income Tax to the Scottish Parliament opens up the possibility of a further option which would remove any pretence that LIT was a "local" tax - namely, to add Xp to each of the Scottish Income Tax rates and to assign the yield from that Xp to local government. However, this option would raise transparency problems as regards both (a) the yield of the Xp for each of the 32 local authority areas and (b) whether the total of that yield would be genuinely additional to the LGF settlement.

Local Sales Tax

28. In a number of countries (eg, the USA) local sales tax contributes to the funding of sub-national government. However, such a tax is less appropriate in a small country such as Scotland where, particularly in the Central Belt, there is a good deal of cross local authority border shopping. And the continuing growth of online shopping makes the link between a sale and a particular local authority even less relevant. A local sales tax would have to differ from VAT in order to avoid EU difficulties.

29. For those reasons, the LGF Review Committee fairly quickly rejected local sales tax as a replacement for or addition to CT.

LVT

30. Advocates of LVT argued with zeal to the LGF Review Committee that this tax should replace CT. However, it was never made clear what advantage a tax on land would have over a tax on buildings, especially to help fund local government services. The argument for a tax on an empty brown-field

site to encourage its development was clear enough, but it was never explained why it made sense to tax the site of a luxury block of flats but not the flats themselves.

Water and Sewerage (W & S) Charges

31. It was rather cynically decided by the then Government when responsibility for water and sewerage services was transferred from local government to new Water Authorities (now Scottish Water) that local authorities should collect W & S charges along with the CT. To facilitate this, W & S charges are banded on the same lines as the CT. Although there might be some overall increase in collection costs, I personally think, on transparency grounds alone, that it would be desirable to move to a situation where Scottish Water collects all its own charges. This would be essential if CT were replaced by a non-property based tax.

32. I wish the Commission well in its difficult task.

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