

THINKING BIGGER ON TAX IN SCOTLAND

USING SCOTLAND'S
LOCAL TAX POWERS TO
THEIR FULL POTENTIAL

Thought paper

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SUMMARY

In recent years the Scottish parliament has seen the devolution of significant new powers over taxation. In many ways the policy debate has been dominated over how these new powers, particularly over income tax, should and could be used. However, the focus on Scotland's new powers has dominated to the exclusion of how pre-existing powers could potentially be helpfully employed in this new context.

Since 1999, Scotland has had full devolution of powers over local taxation. Provided funding from new local taxes goes to fund local government expenditure, Scotland has wide legislative powers to introduce new local taxes alongside existing ones such as council tax and business rates. Local tax powers could provide much-needed additional revenue to invest in public services. But they could also offer crucial opportunities for Scotland to broaden the tax base and to attempt to deliver behavioural change, that may not be available through new tax powers.

This thought paper outlines the existing local government funding context, including recent cuts to local government funding in Scotland, and current funding arrangements, including that Scottish government grants account for over half of local government income. It also considers some of the ongoing reforms to local taxation, including through the forthcoming tourist tax and workplace parking levy.

The paper then looks at a number of international examples of sub-state taxes, before considering which of these international examples could be applicable in Scotland.

The paper considers five illustrative examples of potential new forms of local tax and local funding arrangements in Scotland.

1. A LOCAL INHERITANCE TAX

The paper shows that a local inheritance tax could be possible in Scotland, drawing on a number of international examples of sub-state inheritance or estate taxes. If designed as a flat 10 per cent marginal tax rate above a threshold of £36,000, it could provide up to £200 million of additional revenue per year. If set to work around the current UK-wide inheritance tax (IHT) system, set at a 20 per cent marginal tax rate for estates worth more than £36,000 that do not currently pay UK IHT, it could raise around £300 million per year. Local inheritance tax could be set across Scotland – as with business rates now – or devolved to local authorities. Either way, provided revenue went to fund local government expenditure – whether retained locally, boosting local government budgets as a whole, or freeing-up existing central funding for local government – it could be possible through existing legislative powers held by the Scottish parliament, and collectable through Scotland-based collection agencies.

2. A LOW PAY LEVY AND FAIR WORK BONUS – A LOCAL PAYROLL TAX

The paper outlines that a local payroll tax could be possible in Scotland, drawing on a number of international examples of sub-state payroll taxes. A local payroll tax in Scotland, aimed at increasing tax for low-pay employers, could be set to work around the current UK national insurance payroll tax system for employers. Currently, employers pay no national insurance for each of their employee's earnings between £0 and £8,632 per year. A local payroll tax, or a 'low pay levy',

could be levied on employers in Scotland within this zero-rate tax band. If set at a marginal tax rate of, for example, 3.8 per cent, it could raise up to £600 million per year for local government in Scotland. If combined with a 'fair work bonus', a 100 per cent tax allowance for employers who meet fair work criteria, it could see fair work employers pay no more, if not less, than now. New administration and compliance systems would be required, and data sharing agreements with HMRC could reduce the risk of additional red tape for businesses in Scotland.

A low pay levy and fair work bonus could introduce incentives for employers to move away from low-pay business models and toward fair work practices, while also providing additional revenue for local government or for public services more broadly.

3. A FAIR WORK SUPPLEMENT ON BUSINESS RATES

A further example could see a new 'fair work supplement' added to the existing business rates system in Scotland. This would see employers who do not meet fair work criteria, set out clearly by the Scottish government, pay a supplement on their business rates bills. The supplement could be based on a variety of criteria, including based on a proportion of a business's tax liability for last year (eg a proportion of a company's corporation tax, national insurance or other tax liability for the year-end).

The fair work supplement could provide incentives to employers to move to fair work business models, benefiting employees across Scotland. It could be set locally with revenue retained by individual local authorities or pooled to increase local government funding as a whole.

4. LOCAL INCOME TAX ASSIGNATION

With the devolution of income tax on earnings to the Scottish parliament, there are now new opportunities for tax assignation to the local government level. In line with arrangements from a number of international examples, most notably in Germany, local tax assignation could provide greater long-term certainty for local government budgets, potentially reducing the impact of national political and funding priorities on local government budgets. Assigning a proportion of devolved income tax revenues to local government budgets could be used to replace existing central funding for core local government grants. This would move local government funding out of the annual Scottish government budget process, instead basing local government funding on projections (and reconciliations) for relevant devolved taxes.

A further option could see options for local government to retain *increases* in tax revenue from certain income tax bands. For example, an 'inclusive growth incentive' could see local authorities able to retain increases in per head tax revenue raised from the starter and basic rate income tax bands in Scotland. If a local authority sees increases in revenue per head from workers earning between the personal allowance and median wage, then they would be able to retain the increased tax revenue from doing so. This could provide new incentives on local government to work to increase pay for lower-paid workers, aligning with Scottish government priorities around fair work and inclusive growth.

5. A LOCAL CARBON TAX

Given the climate change emergency the world faces and the target to reach net-zero carbon emissions in Scotland by 2045, it is important to consider potential options offered through local tax powers to help to reduce carbon emissions. This paper considers how a local carbon tax, modelled on Canada's province-level carbon taxes could be introduced in Scotland. In Canada, a new

carbon tax has been introduced, levied on companies importing, distributing and delivering certain fuels for consumption. The carbon tax is set at a rate per tonne of estimated carbon emissions for each fuel, translated to an amount per tonne, kilogram, litre or other unit of fuel. A similar carbon tax could be possible through Scotland's local tax powers, with revenue going to local government to fund carbon-reducing measures and rebates to low income households to limit regressive effects. A local carbon tax could similarly be set at a per tonne rate, either for Scotland as a whole or with some flexibility for individual local authorities, levied on fuels such as coal, gas and oil. As in Canada, this could be implemented through a new registration system for fuel distribution companies with monthly tax returns and could be collected across Scotland or by each of Scotland's local authorities.

Overall this paper does not intend to provide definitive answers on how Scotland's local tax powers should be used to strengthen Scotland's tax system, but its aim is to outline what might be possible and pose questions for discussion and illustrative ideas for debate. Further work would be required to fully cost potential proposals and to fully consider potential collection and compliance issues.

However, the paper does show that Scotland's local tax powers, in the context of recent tax devolution to Scotland, offer opportunities to strengthen Scotland's tax base, deliver behavioural change in line with key Scottish government priorities and provide crucial additional public funding, whether for individual local authorities, for local government as a whole, or for public services across Scotland.

To strengthen Scotland's national tax system, and deliver against key national policy priorities, we may need to think local to consider how Scotland's older powers over local tax can be used to supplement new tax powers at the Scotland level, to deliver a tax system ready to deliver a more progressive Scotland for the future.

1. INTRODUCTION

In recent years we have seen increasing devolution of tax powers to the Scottish parliament. Since the 2014 independence referendum and the recommendations of the resultant Smith Commission, the Scottish parliament has gained new powers in relation to income tax on earnings, and on smaller taxes such as stamp duty (now land and buildings transaction tax), the aggregates levy and landfill tax (air passenger duty is also expected to be devolved in the future). This has led to an increasing debate in Scotland around how to use these new tax powers and, in particular with regard to new income tax powers, it has seen innovation and policy divergence between Scotland and rest of UK tax policy.

However, this focus on new powers may have crowded-out consideration of the potential for older powers in Scotland. Since devolution in 1999, the original Scotland Act 1998 has provided the Scottish parliament with significant powers in relation to local taxation, defined in the Act as taxes from which revenue goes to finance local government. While there has been some policy attention on how to use these quite wide legislative powers, much of the focus has been in relation to how council tax and non-domestic rates (business rates) could be reformed. In 2015 the Local Tax Commission recommended the abolition of the council tax and in 2017 the Barclay Review made a series of cost-neutral recommendations to reform business rates. Additionally, there have been repeated pledges from a range of political parties to reform or replace council tax, including proposals for a local income tax in the early years of devolution and more recently calls for a land value tax most notably from the Scottish Greens.

However, much less recent attention has focused on what could be done with local tax powers to develop new forms of taxation in addition to council tax and business rates. There have been recent moves to introduce a transient visitor levy (tourist tax) and workplace car parking levy in Scotland. While there may be merits in these reforms, without question they will not be significant in terms of the revenue they raise.

We have not seen the same level of attention on how local tax powers could be used in Scotland in innovative ways, as we have for the Scottish parliament's new powers. Given the somewhat restrictive nature of some of the new tax powers, local tax powers could become crucial to broadening Scotland's tax base, driving the behaviours we wish to see to deliver a stronger and fairer economy and delivering reform to Scotland's system of taxation as a whole.

Through this thought paper we wanted to explore the full potential for Scotland's local tax powers and how they could be used in innovative ways to drive a more progressive Scotland, with an aim of considering what is possible rather than necessarily calling for particular policy change at this stage.

2. CURRENT LOCAL TAX ARRANGEMENTS IN SCOTLAND

The original Scotland Act 1998 devolved legislative competence in relation to local government in Scotland to the Scottish parliament. However, the current organisation of local government in Scotland predates this, stemming from the UK government's 1992 reorganisation of local government across the whole of the UK. This saw the creation of 32 local authorities in Scotland, on boundaries that have been left unchanged since.

Local government in Scotland is funded by a mix of Scottish government core grants (the general revenue grant and the smaller general capital grant), ring-fenced grants from the Scottish government, centrally collected local tax revenue (business rates) and direct revenue from other local taxes, fees and charges.

In the early years of devolution, ring-fenced funding for local government – where funding was provided to local government from the Scottish government but with little control over how it could be spent – had grown in importance. However, in 2007, following the election of the first SNP government, a new agreement, dubbed the 'historic concordat', was signed between local government and the Scottish government, removing the vast majority of this ring-fencing in an attempt to move towards more outcome-based funding (Herbert et al 2007).

2.1. CURRENT FUNDING FOR LOCAL GOVERNMENT IN SCOTLAND

The total funding allocation for local government in Scotland from the Scottish government has been under significant pressure in recent years. Allocations to local authorities for day-to-day spending have been falling in real-terms, with reductions in revenue funding between 2013/14 and 2018/19 amounting to 7.1 per cent in real-terms, a steeper decline than the 0.8 per cent reduction to the Scottish government revenue budget over the same time (Burn-Murdoch et al 2018).

The table below outlines revenue funding available to local government in Scotland for 2018/19, including tax and fee revenue and Scottish government funding, and the proportion of funding from each source.

TABLE 2.1

Revenue funding sources for local government in Scotland 2018/19

Source	Funding	Percentage
General revenue grant	£6.774bn	54.2%
Business rates (NDRI)	£2.666bn	21.3%
Council tax	£2.238bn	17.9%
Fees and charges	£0.598bn	4.8%
Specific Revenue Grants	£0.211bn	1.9%
Total	£12.487bn	100%

Source: Berthier et al 2018

The largest source of revenue funding for local authorities as a whole is from the central grant from Scottish government (54.2 per cent of revenue funding), with business rates income and council tax income together representing almost two-fifths of revenue funding. Fees and charges provide less than 5 per cent of funding for local government.

Individual revenue allocations to local authorities in Scotland range from £74 million for Orkney through to £1.25 billion per year for City of Glasgow. Per head allocations range from £1,426 per head for City of Edinburgh council through to £2,108 per head for Inverclyde, £2,258 per head for Argyll and Bute and higher still for the island local authorities (Burn-Murdoch et al 2018).¹

The total allocation for local government in Scotland has seen a real-terms increase of 2.9 per cent for 2019/20, including capital, business rates income and Scottish government grants. However, much of this came from increases in capital funding and ring-fenced funding grants² (specific revenue grants), with non-ring-fenced revenue funding (general revenue grant and business rates income) falling by 1.1 per cent on the previous year (Burn-Murdoch and Campbell 2019).

BOX 2.1: HOW DOES TAX REVENUE AFFECT A LOCAL AUTHORITY'S BUDGET?

Individual allocations to local authorities take account of council tax and business rates income in setting the non-ring-fenced grant funding provided to each local authority. Those councils with higher tax revenue will therefore receive less grant to compensate, with a set level of funding determined by a needs-based formula (known as grant-aid expenditure), with a maximum cap and a minimum floor, to ensure levels of funding across different local authorities do not diverge too far from each other.

This means increases or decreases in tax revenue are usually taken account in setting the local authority's overall budget. However, this need not be the case with new forms of local taxation. It would be a policy decision as to how much of any new revenue was retained by the individual local authority in question (not taken into account in setting the general revenue grant) or whether income is fully pooled at the national level across all local authorities (fully taken into account in setting the general revenue grant) or a mix. Pooling would place a priority on the principle of equity between local authorities while allowing individual local authorities to retain all income from a particular tax would place a priority on local autonomy, risking divergence between local authorities with high levels of tax revenue and those with low.

2.2. CURRENT LOCAL TAXES, FEES AND CHARGES IN SCOTLAND

The two main forms of local taxes in Scotland, and vast proportion of non-Scottish government funding, are business rates and council tax.

Business rates

Business rates are a tax on businesses' properties and are set by estimating the 'rateable value' of a business's property and charging a 'poundage' – currently 49p per £1 of rateable value for 2019/20 – that businesses must pay in tax. The

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- 1 These figures include business rates income and take account of expected council tax income. This means councils with high levels of expected income from council tax will receive lower allocations than others, in line with the GAE needs-based formula described above.
 - 2 These ring-fenced funding grants are known as specific revenue grants and can only be used for specific services. As of 2018 and 2019 these specific grants are for Gaelic, the Pupil Equity Fund, early learning and childcare expansion and criminal justice social work (Scottish government 2019a).

poundage is set nationally across Scotland. Businesses with larger properties also pay a large business supplement of 2.6 pence per pound, on properties valued at more than £51,000 rateable value (for 2019/20).

As well as being set centrally, income is also pooled centrally then distributed back to local authorities through a distribution formula agreed with COSLA. Each council's share of the estimated business rates income for the year ahead is distributed proportionately on the basis of the councils' latest mid-year income returns (Scottish government 2019a). As stated above, each council sees their general revenue grant from government adjusted to take account of high or low revenue from business rates, to ensure local authority areas with lower numbers of businesses, or lower property values do not lose out compared to others.

There are a number of nationwide tax exemptions as part of the business rates system, most notably the small business bonus, which sees businesses with small properties receive a discount on their business rates tax bill of up to 100 per cent. Tax allowances on business rates are estimated to cost up to £750 million per year in lost tax revenue (Scottish government 2018a).

Council tax

The council tax was introduced in April 1993 by the Conservative government under John Major as a replacement for the community charge or 'poll tax' (Scottish Parliament 2004a). There are currently eight council tax bands based on property values assessed as of April 1991. Despite huge changes in property values over the past 28 years, national revaluations of property values have not taken place. The ratios between the eight bands is set centrally, but the amount of council tax can be varied by local authorities capped to a maximum increase of 3 per cent per annum (in real-terms for 2019/20). Local authorities see their grant from the Scottish government adjusted to take account of expected council tax revenues.

Other fees and charges

Other than council tax and business rates, councils also receive income through fees and charges including for social care, environmental services, cultural and related services and planning. Income from these sources has been relatively stable in recent years and makes up a very small proportion of local authority revenue, currently just under £600 million per year (Scottish government 2018c).

2.3. POLICY CHANGE IN RELATION TO LOCAL TAX IN SCOTLAND

After many years of a lack of policy change on local tax, more recently we have seen some reforms to the structure of both business rates and council tax.

Council tax

Following many years of significant increases in council tax rates throughout the early years of devolution, the SNP were elected in 2007 on a promise to freeze and reform council tax. The council tax freeze lasted from 2007/08 through to 2016/17, seeing real-term reductions in council tax bills throughout the early years of austerity. For 2016/17, the Scottish government made a number of smaller reforms to council tax, altering the fixed, Scotland-wide, ratios between council tax bands (increasing council tax bills for those in the highest bands) and also introducing flexibility for councils to increase council tax up to a maximum of 3 per cent each year in cash terms (this has been set at 3 per cent in real-terms for 2019/20).

Since devolution, there have been a number of attempts to consider more fundamental reforms to council tax in Scotland.

The 2006 Burt Review for example considered potential local tax reforms in Scotland with a remit to look at council tax; local income tax; land value tax; options for local business taxation; and any other appropriate models of local

taxation. The review recommended that a new local property tax (LPT) should replace the current council tax system, set as a percentage of the property's value, thus abolishing current banding system. For business rates the review recommended the continuation of the existing system.

In 2014, the Scottish government announced its intention to form the Commission on Local Tax Reform, to consider alternatives to council tax. The cross-party commission was jointly established with CoSLA (Convention of Scottish Local Authorities) in 2015 with a remit 'to identify and examine alternatives that would deliver a fairer system of local taxation to support the funding of services delivered by Local Government'. The final report was published in late 2015 (Local Tax Commission 2015). The overriding conclusion and recommendation was that the 'council tax system must end'. It recommended that multiple forms of taxation should replace council tax, rather than one single tax instrument. The aim of this was to provide greater flexibility and autonomy for local government as well as greater fairness for households in Scotland. The commission also stated that its predominant view was that a taxation on domestic property should continue to form part of the mix of local taxation, whether as a reformed council tax or a proportionate capital value-based tax. Following the 2016 Scottish parliament election the Scottish government did not take up the recommendations of the commission, instead making smaller reforms to council tax as outlined above.

Business rates

Similarly to council tax, after many years of little change in local business taxation, the Scottish government has been taking some steps towards reform in recent years.

In the early years of devolution there was little focus on potential reforms to business rates in Scotland. As stated above, business taxation was within the remit of the Burt Review, but it concluded that the current system should continue unchanged (Burt 2006). In 2007, the newly elected SNP government introduced a new small business bonus, providing a Scotland-wide tax rebate of up to 100 per cent for businesses with small properties.

However, it was not until the Barclay Review was established in 2016 that a Scottish government considered more fundamental reform of local business taxation in Scotland. The remit of the review was "to make recommendations that seek to enhance and reform the non-domestic rates (also sometimes referred to as business rates) system in Scotland to better support business growth and long term investment, and reflect changing marketplaces, whilst still retaining the same level of income to deliver local services on which businesses rely" (Barclay 2017). Crucially this meant that recommendations made from the Barclay Review needed to be cost-neutral.

The review reported in 2017, making 30 recommendations for reforms to business rates in Scotland, including a recommendation to evaluate the effectiveness of the small business bonus scheme. It concluded that property, based on rental values, was something that should be retained as a main part of the local business tax base. In addition, it considered other options that could be delivered, in addition to a local business property tax. This included a local land value tax, which the review highlighted would need significant further analysis, and a turnover, sales or profit tax, which the review could see merit in, for some sectors, alongside a local property tax for business. Following its publication, the Scottish government accepted many of the recommendations of the Barclay Review and is in the process of implementation of many (ibid).

Other policy developments on local tax in Scotland

There have been a number of proposals for reform to local taxation, particularly around council tax, since devolution.

In the early years of devolution, the Scottish Liberal Democrats, the SNP and the Scottish Socialist Party (who had representation within the Scottish parliament between 1999 and 2007) each had a policy to replace council tax with a local income tax.

As of the last Scottish parliament elections in 2016, the parties' positions on local tax had shifted. The SNP's manifesto outlined its plans for reforms to the bands for council tax and the ending of the council tax freeze, which became Scottish government policy following their election (SNP 2016). The Scottish Conservatives backed smaller-scale changes to the ratios between council tax bands and called for a review of local government funding (Scottish Conservatives 2016). Scottish Labour proposed scrapping of the council tax to be replaced by a new local tax based on property values, that they claimed would see 80 per cent of council tax-payers better off (Scottish Labour 2016). The Scottish Greens proposed replacing the council tax with a progressive property tax called a residential property tax, set at 1 per cent of property values above a tax-free allowance of £10,000. They stated this would be a step towards a long-term aim of introducing a land value tax (Scottish Greens 2016). Finally, the Scottish Liberal Democrats in their 2016 manifesto, stated they were attracted to the option of a land value tax and that time should be taken to explore this option as an alternative to the existing council tax (Scottish Liberal Democrats 2016).

Furthermore, in 2018, the Scottish government and CoSLA began a local governance review in Scotland, with the stated ambition of empowering local decision-making. The review is ongoing, and a recent statement by the Scottish government and CoSLA outlined that there was not an intention to rush to legislation in this area, and further work with local communities will be required going forward (Scottish government 2019b).

Most recently, the SNP and Scottish Greens reached an agreement in relation to local government as part of negotiations to secure the Scottish Greens' support for the 2019/20 Scottish Government budget. As outlined in the previous section, local government has seen significant spending cuts from the current Scottish government in recent years. This has meant local government funding has received significant political attention as a policy area from opposition parties. In return for the Scottish Greens' support to pass the budget, the Scottish government agreed to support legislation to bring forth two new local taxes, a tourist tax and a workplace parking levy; to bring forward a three year funding settlement for local government from 2020/21 budget onwards; and to develop a 'rules-based framework' for local government funding for the next parliament. The Scottish government also agreed to convene new cross-party talks on a replacement for council tax, and if agreement is reached, to publish legislation by the end of this parliament (with that legislation taken forward in the next parliament) (Scottish government 2019c).

Tourist tax and workplace parking levy

Following the SNP's agreement with the Scottish Greens to consider a tourist tax and workplace parking levy in Scotland, the Scottish government has begun the process of implementing both.

The workplace parking levy is a proposal to grant Scottish local authorities the ability to levy an annual charge on organisations based on the number of car parking spaces they have for use by their employees (Rehfishch 2019). The stated aim of the levy is to raise revenue but also encourage greener forms of travel to and from work, with the proposal being modelled on a levy currently in place in Nottingham, established by Nottingham City Council. The Scottish parliament agreed legislation that will allow local authorities in Scotland to decide whether to introduce a scheme or not, based on a licensing approach. Where a levy was

in place, employers would apply to the respective council for a licence for each car parking space, with a fee charged per space (ibid). In Nottingham, the scheme is estimated to raise around £9 million per year. Relative to Scotland's budget as a whole, or even individual local authority budgets, this would represent a tiny fraction of public spending.

Finally, the Scottish government is currently consulting on a transient visitor levy, known as a tourist tax, following its agreement with the Scottish Greens, and following calls from CoSLA and a number of individual local authorities (most notably Edinburgh City Council). They have agreed to introduce legislation that, if passed, would see councils given the power to introduce a levy by 2021 at the earliest. Depending on its design it is likely a tourist tax in Scotland would raise only tens of millions of pounds each year. Edinburgh City Council's latest plans would see a £2 per room per night tax levied, up to seven nights, and would be estimated to raise around £15 million per year (City of Edinburgh Council 2018).

For both taxes, it has yet to be decided whether revenue would be retained locally, pooled nationally for local authority budgets, or some mix. This would be important as it is likely that some local authorities, such as the City of Edinburgh Council, are more likely to be able to raise higher levels of funds through these sources than others.

3.

INTERNATIONAL EXAMPLES OF SUB-STATE TAXES

While we have not seen fundamental reform to local taxation in Scotland since devolution in 1999, there are a wide variety of international examples of innovative taxation beneath the level of national government. These sub-state taxes offer examples that could be instructive for Scotland to consider for potential local tax options, alongside the current council tax and business rates system (whether reformed or otherwise).

There are a variety of different taxes that are administered by state and sub-state government levels internationally. In broad terms these include:

1. **personal income taxes**
2. **business income taxes**
3. **payroll taxes**
4. **wealth and property taxes**
5. **taxes on consumption, goods and services.**

Internationally, there are a mix of examples of taxes that are fully devolved, with rates and levels of taxation set locally, and revenue retained at the sub-state level. Equally, there are other examples of tax assignment to the sub-state level, where rates and tax levels are not devolved but revenues flow to sub-state government. Equally, some, if not most examples of sub-state taxes have a mix of devolution and assignment, often in an attempt to balance local autonomy with equity considerations across regional and local areas.

This section considers examples of sub-state taxes from across the world and provides case studies that may be instructive for the debate in Scotland.

3.1. PERSONAL INCOME TAXES

While generally administered at a national level around the world, income taxes are occasionally levied at both national and local level.

In Denmark there are two income taxes collected, one a national income tax and one a municipal income tax set by each of Denmark's 98 municipalities. The municipal tax is a flat rate which sits alongside the national tax and uses the same allowances and tax base. For 2019, the municipalities have local income tax rates of between 22.8 per cent and 27 per cent (Statistics Denmark 2019). Local tax provides a significant proportion of tax revenue for municipalities in Denmark, representing over 27 per cent of all tax revenue in 2016 (OECD 2016).

Other countries also see assignment of income tax revenues to the sub-state level. In Germany, the 16 Lander are funded through a financial framework which aims to provide for an element of fiscal equalisation across Germany. This includes assignment of shares of federal taxes to the Lander. The framework is a four stage process to ensure the finances of each Lander do not diverge too far, starting with a vertical transfer (in essence tax assignment of joint taxes to the Lander and local authority levels), a horizontal transfer (distribution of the tax revenue within the

Lander level), financial equalisation (redistribution of revenue from better-off Lander to poorer Lander (based on per-head spend), and finally supplementary federal grants to bring spend in the poorer Lander up to close to the average (they receive 77.5 per cent of any shortfall beneath 99.5 per cent of the average spend per head across Germany). Income tax is a joint tax in Germany, where rates are set across Germany at the federal level but with consent from Lander, with revenues being shared. Currently, 42.5 per cent of income tax revenue is assigned to the Lander based on residency, alongside other joint taxes (including VAT and corporation tax) (Bundesministerium der Finanzen 2018). From 2020, Germany is introducing reforms to this framework which will place a greater emphasis on federal transfers than Lander-to-Lander transfers (Dmitrieva et al 2017).

A number of other countries also devolve or assign shares of income tax revenue to sub-state government, including Belgium, Canada, Spain and Switzerland (Scottish parliament 2014b).

3.2. BUSINESS INCOME TAXES

Corporation tax, or taxation on corporate income or profits, is generally set at the national level, with only a small number of countries seeing devolution of power to set corporation tax rates. Within the EU, member states are not allowed to set differential corporation tax rates, but there is some precedent which allows for differential rates through devolving the power to do so to sub-state levels.

In 2011, the UK government undertook consultation in relation to devolving the power to set corporation tax to the Northern Ireland assembly and passed legislation, that has not yet been commenced, to devolve corporation tax to the Northern Ireland Assembly (HM Treasury 2011, UK parliament 2018). This followed increasing pressure within Northern Ireland to match the Republic of Ireland's low corporation tax regime. Equally, separate reviews in Scotland and Wales over the last 10 years have considered devolution of corporation tax, and rejected the idea due to risks over fluctuation in revenues, cross-border flows within the UK and tax competition across the UK (Smith 2014, Holden 2010, Bardens and Webb 2012).

Internationally, Canada, Germany, Italy and Japan have elements of devolution over forms of corporation tax to their respective sub-state governments (OECD 2019). In Germany for example, revenues from federal corporation taxes are shared (in a similar way to income tax revenue above) and in addition, Lander can set and levy a local trade tax on businesses (KPMG 2019). In Italy, local states can levy a regional production tax *imposta regionale sulle attività produttive* (IRAP) which can be varied slightly at the regional level (up or down by just under 1 percentage point) (PwC 2019a). In Japan, corporations must pay a local enterprise tax, set nationally (PwC 2019b), and in Canada the provinces can set a corporation tax rate on top of the Federal rate (PwC 2019c).

3.3. PAYROLL TAXES

A payroll tax is a tax paid by employers and/or by employees on the wages paid to employees. The tax is based on wage levels either per employee or for the workforce as a whole (in the case of employers).

National insurance is an example of a form of payroll tax in the UK, paid both by employee and employer, based on individual employee earnings. In addition, internationally, a number of countries see devolution of payroll taxes.

Several states and their cities in the US impose a local payroll tax. In Colorado, for example, a number of cities charge a payroll tax called an 'occupational privilege tax' (OPT). In the city of Denver, the OPT is charged for every employee with at least \$500 per month in gross wages. Both employees and employers are required to

pay the OPT, with employees paying \$5.75 per month and employers an additional \$4.00. Employers doing business in Denver but not based in the city are also liable to pay the OPT.³

In California, on top of federal payroll taxes such as unemployment tax, Medicare tax and social security tax, they employ a state unemployment insurance (SUI), which is a tax for new employers at 3.4 per cent for employees earning more than \$7,000 per year. Existing employers pay between 1.5 per cent and 6.2 per cent depending on previous unemployment experience, ie those who make fewer employees unemployed will pay a lower rate (EDD 2019).

In Canada, there has been some asymmetrical devolution in relation to social security, with Quebec having a pension plan in many ways separate to the rest of Canada. Likewise, some cantons in Switzerland levy taxes to pay for social insurance (Nicol 2014b).

Within the UK, there has been some consideration in Wales of how a social insurance scheme could be developed to pay for social care. One of the options would be a contributory scheme for social care, similar in design to a number of social security taxes internationally, developing a long-term funding stream for social care in Wales (Holtham 2018).

3.4. WEALTH AND PROPERTY TAXES

Internationally, there is a great deal of devolution of wealth taxes and property taxes. As in Scotland, where property tax makes up the overwhelming majority of local taxes for both households and businesses, other countries commonly devolve taxation over property due to its stable revenue source and immovable nature. However, there are also a number of examples of sub-state taxes over other forms of wealth and assets other than property.

Inheritance and estate taxes

Some sub-state and local governments employ an inheritance tax or an estate tax, levied on the value of a deceased person's assets or levied based on the circumstances of the individual inheriting those assets.

This type of sub-state taxation is very common in the US. In addition to the federal US-wide estate tax, 18 states in the US levy their own estate or inheritance tax too. Most have a threshold or zero-rate band (as in the UK) beneath which the tax is not payable. Washington has the highest top marginal estate tax rate of 20 per cent, while Nebraska's relatively flat 18 per cent tax rate for non-related individuals is the highest effective tax rate at the state level. This is levied on top of a federal rate of 40 per cent (albeit only on estates worth more than \$5.5 million). It is typical for smaller estates to be exempt from tax and for transfers to spouses to be exempted too (Walczak 2017).

Equally, there are other instances of devolution over inheritance or estate taxes. In Belgium rates of inheritance can be varied at the sub-state level, and in Germany, the Lander are assigned 100 per cent of inheritance tax revenue (albeit with rates set across the country). Likewise, the autonomous regions of Spain have some flexibility around the tax base for inheritance tax.

Wealth taxes

Internationally, there has been a trend in recent years away from wealth taxes, whether at the national or sub-state level. However, four OCED members still levy wealth taxes. Revenues from wealth taxes are overall usually rather low.

3 See: <https://www.denvergov.org/content/denvergov/en/treasury-division/business-taxes/occupational-privilege-tax-opt-information.html>, accessed 19 August 2019.

However, in Switzerland, 3.7 per cent of all tax revenue is raised through its wealth taxes which are devolved to the cantons (OECD 2018). By law, each canton must have a wealth tax, however rates and thresholds are broadly decided at canton level. The wealth tax is levied in all cantons and municipalities, comprising all the taxpayer's assets and rights that have a cash value, assessed at market value. These taxable assets include real estate, movable capital assets, cars, redeemable life insurance and business assets among others. The tax base for the wealth tax is the net wealth, or gross wealth reduced by the sum of taxpayer debt. There are deductions that can be made which vary from canton to canton.

Land-value tax

There has been a great deal of interest in a land value tax in Scotland for some years. As outlined above, the Scottish Green party in particular have been proponents of a land-value tax to replace the council tax. The Scottish government asked the Scottish Land Commission to undertake work to consider a land-value tax for Scotland and the further work, now ongoing, required to ascertain its feasibility (Hughes et al 2018). Equally, IPPR has published a number of reports looking at land value tax in the context of the rest of the UK (Murphy 2018).

In terms of international examples, there are a number of local land value taxes in operation where taxes are set based on the value of land occupied or owned by households or businesses. The state of Queensland in Australia has a state-level and local-level land value tax for both companies and individuals. The tax is levied on larger estates and has exemptions including for agricultural land, charities and dwellings. Valuations are conducted annually by the state (ibid).

Estonia's land value tax was established following its independence from the Soviet Union in the early 1990s. It is based on a zoning system where land is zoned into commercial and residential areas, and valued on a broad rather than individual basis, with concessions for agricultural land. Tax rates range between 0.1 per cent and 2.5 per cent based on tax bands, and revaluations have not taken place since 2000. The tax is collected at the state level and distributed locally (ibid).

Other countries also have forms of land value taxation in place at the state and sub-state level, including Denmark, Singapore and some states in America, and many other countries have or have had different forms of land value tax.

3.5. TAXES ON CONSUMPTION, GOODS AND SERVICES

Sales and VAT

There are a number of examples of local forms of sales taxes, levied on purchases by individuals and companies, and indeed sales taxes are in the top three of taxes devolved across the countries in the OECD by revenue (Nicol 2014a). In Japan, the current consumption tax rate is 8 per cent, inclusive of a local consumption tax rate of 1.7 per cent. This will be increased from 1 October 2019 to a 10 per cent tax rate, with a 2.2 per cent inclusive local rate. Equally, in the US and Canada local sales taxes are commonplace. In the US, 45 states collect sales taxes, and 38 states have local level sales taxes too (Walczak and Drenkard 2018). Most recently, through Supreme Court judgements, this has been expanded to allow states to levy an internet sales tax, as well as on physical sales in a given area. Furthermore, in Canada, there are a range of sales taxes levied at the provincial level.

Within the EU, it is not possible for member states to set differential rates for VAT within that member state (except for a small number of exemptions). This means devolution is not possible. However, assignation is more commonplace. In Scotland, following the Smith Commission and latest wave of devolution to Scotland, proposals were agreed to assign a proportion of VAT revenues in

Scotland to the Scottish parliament. However, these proposals have not yet been implemented due in part to major concerns in relation to data collection and levels of accuracy. Given the high level of revenue raised through VAT, even small errors in data could have significant impacts on the Scottish parliament's budget.

Local carbon tax

Carbon taxes are a form of consumption tax that aim to tax the potential carbon emissions of a given product. Usually applied to fuels, they aim to not only raise revenue but also serve to disincentivise the use of fuels that contribute to climate change.

As of May 2018, 45 national and 25 subnational jurisdictions have put in place carbon pricing or taxes (World Bank 2018), with governments raising approximately US\$33 billion in carbon pricing revenues in 2017. This represents an increase of nearly US\$11 billion compared to the US\$22 billion raised in 2016 (ibid).

Canada has one of the most recent examples of a carbon tax regime. The current Liberal government has enacted a carbon tax on oil, coal and gas initially set at CA\$15, rising to a planned CA\$50 per tonne by 2022, in addition to a carbon trading scheme for larger industries. This Canada-wide tax was pre-dated by carbon taxes in four of Canada's provinces and territories – British Columbia, Alberta, Ontario and Quebec – which will align with the federal tax for 2018-22. Evidence so far suggests that, in the case of British Columbia at least, the carbon tax implemented has helped to reduce carbon emissions with only negligible effects on economic growth. Equally, public support for the tax has increased despite increases in the tax rate (Murray and Rivers 2015). All revenue will be returned to the provinces and territories it was raised in, with those with a carbon tax already in place able to spend the resources as they wish. For those without a carbon tax already in place, the revenue from the federal tax will be redistributed directly to households in those areas through tax rebates (Government of Canada 2019).

4.

WHAT CAN BE ACHIEVED IN SCOTLAND?

There are clearly many examples of local tax innovation outside of Scotland and the UK. However, what can be done within a devolved setting in Scotland becomes important as we consider options that could be achieved through the Scottish parliament.

4.1. SCOTLAND'S NEW TAXATION POWERS

The Scottish parliament has seen new powers over taxation devolved in recent years, including income tax on earnings, stamp duty (now replaced by land and buildings transaction tax) and smaller taxes over aggregates levy, landfill tax and air passenger duty (in the future). However, while the revenue raised by these taxes will see almost half of the Scottish parliament's revenue raised by taxes in Scotland, and while they have offered the opportunity for policy divergence between Scotland and the rest of the UK (most notably in developing a more progressive Scotland income tax system on earnings), in many ways the individual taxes are relatively restricted in scope.

For example, while the devolution of income tax on earnings has offered far greater scope for the Scottish parliament to raise its own revenue, the tax is on earnings-only and only earnings above the personal allowance, with control over the tax base and tax allowances not devolved. This brings risks around higher earners moving income from earnings to dividends, or in taxpayers moving residency from Scotland to the rest of the UK.

Likewise, the overwhelming proportion of tax revenue raised in Scotland is now levied through only two forms of taxation: income and property. While these often represent more stable forms of tax revenue, they still leave the Scottish parliament's budget to some extent exposed to economic shocks on either.

The original Scotland Act 1998 devolved very wide powers when it comes to local taxation in Scotland to the Scottish parliament. The act states that "local taxes to fund local authority expenditure" are fully devolved to the Scottish parliament.⁴ In the absence of other limiting statute, whether from the UK parliament or internationally (such as EU laws around VAT), this means that the Scottish parliament could, in theory, introduce a broad range of new forms of taxation in Scotland, as long as the revenue is used to fund local authority spending only.

Therefore, it is likely that there would be few legislative constraints on introducing in Scotland many of the forms of sub-state taxation seen elsewhere in the world. Instead, it is likely to be other considerations, most notably around collection and compliance, that constrain what could be done in Scotland, and other considerations that act as the main barriers to local tax innovation in Scotland.

⁴ See: Schedule 5, Reserved Matters, Part II, Head A – Financial and Economic Matters, A1. Fiscal, economic and monetary policy. <https://www.legislation.gov.uk/ukpga/1998/46/contents>

4.2. THE BENEFITS OF SCOTLAND'S PRE-EXISTING TAX POWERS

Using local tax powers could have advantages over Scotland's newer tax powers.

Firstly, using local tax powers could allow the Scottish government to introduce new taxes that broaden the Scottish tax base, which is currently dependent on taxes on earnings and on property taxation. This could better future-proof Scotland's public finances against disruption in the economy, climate change and demographic change, not to mention better protected from cross-border flows in taxpayers between Scotland, the rest of the UK and the rest of the world.

Secondly, the introduction of new forms of taxation, using local taxation powers, could allow greater ability for the Scottish government to use tax powers to drive the behaviour changes Scotland needs to see around some of the key challenges it faces looking ahead. New forms of local tax could help to drive the change in behaviour we need to see across the economy to deliver on some of the Scottish government's key priorities such as climate change, inclusive growth, fair work, and reducing poverty and inequality.

Lastly, new forms of local taxation could provide crucial funds to protect and improve funding for public services in Scotland, raising new revenue at a time of significant financial constraint. Using local taxation powers would mean revenues from new taxes needed to go to local government, but this additional revenue could be used to increase public funding in a variety of ways, whether increasing individual local authority budgets, local government funding as a whole or in freeing-up some or all of the current Scottish government funding that goes to local government (currently just under £7 billion per year).

Overall, within the current devolved settlement, it is therefore the Scottish parliament's powers over local taxation that offer perhaps the best opportunity to introduce new and innovative forms of taxation. These new forms of taxation could help to drive the behaviour change needed to meet the challenges facing Scotland, broaden the tax base in Scotland, future-proof Scotland's finances against economic shocks or cross-border flows, all the while offering opportunities to potentially increase tax revenues and protect public funding over the long-term.

5.

NEW IDEAS FOR LOCAL TAXES IN SCOTLAND

This thought paper aims to stimulate debate in Scotland around the tax system and, in particular, to explore how local tax powers could be used to improve the tax system in Scotland. In doing so we wanted to outline a number of illustrative examples of potential new local taxes that are likely within the powers of the Scottish parliament and could be worth further consideration. In particular, we wanted to consider options that have received less policy attention in Scotland through recent waves of devolution.

5.1. A LOCAL INHERITANCE TAX FOR SCOTLAND

A local inheritance tax is potentially possible through Scotland's existing local tax powers, as long as revenue go to fund local government expenditure. As outlined in section 3 there are many countries outside of the UK that see inheritance, estate or gift taxes operate at the regional or local level.

Current UK-wide inheritance tax

The UK-wide inheritance tax is a tax on the assets of a deceased person's estate. For 2019/20, inheritance tax is levied at a marginal tax rate of 40 per cent, but no inheritance tax is payable on the first £325,000 of an estate's value or usually on any assets passed on to a spouse, civil partner or charity. Equally, if a house is passed on to children or grandchildren, the threshold can increase to £475,000. Furthermore, this threshold can be shared with a spouse or civil partner, meaning the threshold on an estate can reach £950,000 before any inheritance tax is levied. The executor for the estate ensures inheritance tax is paid to HMRC in line with the law and those that inherit assets do not usually pay tax on them.

In 2015/16, the latest year for which statistics are available, inheritance tax raised £4.3 billion across the UK, with £213 million raised in Scotland. Just over half of all inheritance tax revenue across the UK comes from London and the South East of England. In Scotland, only 2.2 per cent of deaths were liable for any inheritance tax, compared to 4.2 per cent across the UK. Half of all estates and 65 per cent of the value of all estates above the threshold receive zero inheritance tax due to a transfer to a spouse or partner (HMRC 2018a).

Table 5.1 below shows the number of estates administered in Scotland each year, their total value and their average value. In Scotland there is a separate, lighter-touch administrative route for 'small estates' worth £36,000 or less, compared to 'ordinary estates' worth more than £36,000. The table shows that the average value of estates in Scotland is far below the inheritance tax threshold, with the average value of an 'ordinary estate' in Scotland in 2016/17 was just under £250,000. The current £325,000 (2019/20) inheritance tax threshold is high compared to the average value of estates in Scotland.

TABLE 5.1

Value of estates in Scotland 2012/13 to 2016/17

Year	Ordinary Estate – a value more than £36k			Small Estate – a value of £36k or less		
	Confirmed ⁴	Amount ¹	Average Amount ²	Confirmed ⁴	Amount ¹	Average Amount ³
2012/13	21,107	£4,937m	£234,000	2,605	£67m	£25,700
2013/14	21,670	£4,658m	£215,000	2,339	£56m	£24,100
2014/15	21,948	£5,283m	£241,000	2,297	£53m	£23,200
2015/16	22,984	£5,492m	£239,000	2,129	£49m	£23,100
2016/17	22,586	£5,582m	£247,100	1,947	£44m	£22,800

Notes: 1. Figures have been rounded to the nearest £1,000,000.

2. Figures have been rounded to the nearest £1,000.

3. Figures have been rounded to the nearest £1,004.

4. Confirmation is a legal document from the court giving the executor(s) authority to uplift any money or other property belonging to a deceased person from the holder (such as the bank), and to administer and distribute it according to law.

Source: Scottish government 2018d

Options for a local inheritance tax in Scotland

A local inheritance tax could be introduced using local tax powers in Scotland, provided the revenue went to local government. A local inheritance tax would be very progressive, given on most recent estimates, 20 per cent of adults in Scotland have zero or net-negative financial wealth, and 35 per cent of adults have zero or net negative property wealth (median net family wealth per adult, by wealth percentile: Scotland, 2014-16 (nominal prices)) (Bangham and Judge 2019). Only those in the top 10 centiles in Scotland have sufficient wealth to exceed the current UK-wide inheritance tax threshold of £325,000 (2019/20), and even fewer would have wealth that could surpass the effective threshold available to those who share their inheritance tax allowance with a spouse or civil partner and pass property onto children or grandchildren.

Table 5.2 shows that the total value of the estates administered in Scotland in 2016/17 was over £5.6 billion. Estates with a value of less than £325,000, and so under the current UK-wide inheritance tax threshold, made up the vast majority of estates by value, worth over £4.7 billion. Only £900 million worth of estates had a value of £325,000 or more, and so were potentially liable for inheritance tax. IPPR's recent work has shown that wealth inequalities are likely to widen in future years as returns to capital outstrip returns from labour (Roberts et al 2018).

TABLE 5.2

Value of estates in Scotland above and beneath the £325,000 inheritance tax threshold for 2014/15 to 2016/17

Financial year	Value of estates in Scotland		
	Worth £325,000 and above	Worth less than £325,000	Total value
2014/15	£800m	£4.5bn	£5.3bn
2015/16	£900m	£4.7bn	£5.5bn
2016/17	£900m	£4.7bn	£5.6bn

Note: Rounded to nearest £100m.

Source: IPPR Scotland calculations using data requested through the Freedom of Information Act from the Scottish government and Scottish government 2018d

A local inheritance tax could be designed as a flat tax paid in addition to the existing UK-wide inheritance tax, or it could be designed to sit underneath the current threshold of UK inheritance, in essence acting to reduce the inheritance tax threshold in Scotland to beneath that seen across the UK.

A flat local inheritance tax

As an illustrative example, a flat local inheritance tax could be set at a marginal tax rate of 10 per cent above a threshold of £36,000. This would see no local inheritance tax levied on 'small estates' with instead a flat local inheritance tax paid on all 'ordinary estates'.⁵ This would be paid alongside the existing UK-wide inheritance tax, meaning estates valued between £36,000 and at least £325,000 would pay a combined marginal inheritance tax rate of 10 per cent (in the absence of other tax allowances), and those above the existing inheritance tax threshold of at least £325,000 would pay a combined marginal inheritance tax rate of 50 per cent (40 per cent UK inheritance tax plus 10 per cent local inheritance tax) (see table 5.3).

This would be progressive in its own terms given wealth distribution in Scotland, and furthermore the £36,000 threshold would see higher value estates pay higher amounts and greater proportions of inheritance tax.

Based on the value of estates over the last five years, a flat local inheritance tax, set at a marginal tax rate of 10 per cent, paid above a threshold of £36,000, could raise around £200 million per year in Scotland (assuming no behavioural changes and assuming no local inheritance charge on transfers to spouses or civil partners as per existing UK inheritance tax).

A 'stepped' local inheritance tax

A second illustrative example, could see a local inheritance tax in Scotland, charged only on ordinary estates that do not currently pay UK-wide inheritance tax (those valued between £36,000 and at least £325,000). This would see a local inheritance tax hang under the existing UK-wide inheritance tax system, creating a (combined) 'stepped' inheritance tax system (see table 5.3 below).

For example, a 20 per cent marginal inheritance tax rate on estates valued between £36,000 and £325,000 would see a zero rate inheritance tax on 'small estates' valued less than £36,000, a 20 per cent marginal tax rate on those values between £36,000 and the existing UK-wide inheritance tax threshold of at least £325,000, leaving the existing 40 per cent marginal tax rate for those estates that qualify to pay the current UK-wide inheritance tax system. A local inheritance tax designed like this could raise up to £300 million per year assuming no behavioural changes and assuming no tax was levied on transfers to spouses and civil partners as per the UK inheritance tax system.

⁵ Small Estates have a different and lighter-touch administrative route in Scotland, which would make charging a local inheritance tax on these estates more difficult and arguably less desirable.

TABLE 5.3**Marginal inheritance tax rates under illustrative ‘stepped’ and ‘flat’ local inheritance tax options**

	Current UK-wide inheritance tax	Illustrative ‘flat’ local inheritance tax	Combined inheritance tax under ‘flat’ option	Illustrative ‘stepped’ local inheritance tax	Combined inheritance tax under ‘stepped’ option
Value of estate	Tax rates				
0 - £36k	0%	0%	0%	0%	0%
£36k to £325k	0%	10%	10%	20%	20%
£325k or above	40%	10%	50%	0%	40%

Note: Estates valued at less than £36,000 are defined as ‘small estates’ in Scotland. Those valued at more than £36,000 are defined as ‘ordinary estates’. Small estates have a different, and lighter touch, set of rules.

The current inheritance tax threshold is £325,000 (2019/20). However, this tax-free allowance can be shared with a spouse or civil partner taking the potential threshold to £650,000. Equally, up to £150,000 can be added if a house is passed on to children or grandchildren taking the threshold up to a potential £950,000 before the current 40 per cent rate of inheritance tax is charged.

Source: IPPR Scotland analysis

Increasing public revenue and broadening Scotland’s tax base

As stated, to be able to use Scotland’s local tax powers to implement a local inheritance tax, the revenue would need to go to fund local authority expenditure. A link between any revenue from a new local inheritance tax and new investment into social care could therefore be a logical step. Alternatively, the revenue could be used to free-up some of the Scottish government grant provided to local authorities. However, either way a local inheritance tax could provide significant additional resources for public spending in Scotland.

A local inheritance tax could be set at a Scotland-wide level, with revenue pooled centrally and assigned to local authority budgets, rather than retained by individual local authorities. This would be in line with arrangements for business rates now. This would be in keeping with existing equalisation measures, ensuring that those local authorities likely to have a concentration of wealth do not diverge too far from those authorities less able to benefit from this new revenue.

Equally, a local inheritance tax could be varied locally, potentially above a Scotland-wide floor, with at least a proportion of the increased revenue retained by the local authority in question. However, retention of revenue raised by individual local authorities may allow those areas with greater numbers of high net-wealth households to benefit to a far greater extent than those with lower numbers. Given wealth distributions in Scotland this is likely to benefit some of the better-off parts of Scotland.

In terms of the Scotland tax base, a local inheritance tax would act as a form of wealth tax, helping to broaden the tax base in Scotland beyond its current reliance on property taxation and personal earnings. IPPR has undertaken a great deal of work in recent years looking at the importance of better balance taxation on wealth in the UK as a whole, including through the Commission on Economic Justice (Roberts et al 2019). Equally, a local inheritance tax is likely to be one that increases over time, as Scotland’s population ages. The Resolution Foundation has outlined projections for inheritance tax in England, showing inheritance levels are projected to increase by the 2030s to twice the level they are now (Gardiner 2017).

If similar trends were to take place in Scotland, a local inheritance tax could see increasing tax revenue over time.

Collection

A local inheritance tax in Scotland could place a legal obligation on executors to ensure any local inheritance tax is paid to a Scotland collection agency (for example Revenue Scotland), in the same way that UK inheritance tax is paid now to HMRC. Aligning with UK-wide rules for inheritance tax (other than the threshold and rate) would likely make collection and compliance easier.

5.2. A LOCAL EMPLOYERS' PAYROLL TAX – A LOW PAY LEVY AND FAIR WORK BONUS

As outlined in section 3 there are a number of examples of local payroll taxes internationally. A local payroll tax could be possible to be delivered in Scotland through local tax powers provided revenue goes to local government budgets.

Current UK-wide employers' payroll tax – employers' national insurance contributions

Currently the UK national insurance system sees employers pay a national insurance contribution of 13.8 per cent on their employees' wages above a secondary threshold (currently £8,632 per year for 2019/20). Employers do not pay national insurance on employees' earnings beneath this threshold, in essence reducing the tax burden on low pay employers. This structure of national insurance for employers was introduced in 1998, prior to the introduction of the minimum wage, in an attempt to increase wages for the lower paid and encourage employers to increase employment levels (Taylor 1998).

However, there are several potential negative outcomes from this tax structure. Firstly, it is cheaper for employers to employ larger numbers of low-paid workers than to employ one single higher-paid employee, as lower-pay employers pay less national insurance per pound of payroll than higher-paid employers. Equally, there is potentially a cliff-edge at the point of the secondary threshold, whereby it becomes more expensive for employers to give pay rises and offer career progression to low paid employees. Furthermore, since the introduction of the minimum wage, the risk of taxing low pay leading to lower wages for low-paid workers has lessened, with a legal floor meaning employers cannot (legally), below this point, pass on tax rises in lower wages for low-paid employees.

The cost of the secondary threshold is also very significant, at £30.4 billion per year across the UK. With 8 per cent of the total UK-wide employer NIC contributions coming from Scotland (HMRC 2018b), the cost of the secondary threshold could be up to £2.4 billion per year in Scotland (HMRC 2019).

Options for a local payroll tax in Scotland

A local payroll tax would add a tax or charge on businesses, calculated based on their payroll costs, and would be in line with a number of international examples outlined in section 3.

In exploring options for a local payroll in Scotland, we were particularly interested in how a local payroll tax could help to not only raise new public funds, but also to deliver against Scottish government priorities of fair work and inclusive growth, designed in way which would aim to boost income for low paid workers in Scotland.

A low pay levy and a fair work bonus

As an example a local payroll tax could be designed to increase the tax burden on low-pay employers. One way to do this could be to charge a new local payroll tax on employers' payroll costs beneath the current £8,632 secondary threshold for employers' national insurance contributions. This would see employers pay tax on their employee's earnings between 0 and £8,632 per year.

As an illustration, a low pay levy of this sort, set at, for example, a marginal tax rate of 3.8 per cent of a firm’s payroll under the secondary threshold in Scotland, would see employers pay up to around £328 per employee. This could raise up to around £600 million per year (assuming no behavioural change).

In addition, some of the funding from this new local payroll tax could be used to offer a rebate or tax allowance on an employer’s payroll tax obligation further up the income spectrum. If this rebate was set a level to at least reimburse employer’s low pay levy contributions for those employees earning, for example, between the real living wage and median wage it would mean fair work employers would see no increase in their payroll tax contributions.⁶ Equally, a fair work bonus could be set to exceed the cost of the low pay levy, meaning fair work employers could see a reduction in their payroll tax obligations compared to now. A fair work bonus of this sort would offer an incentive to employers to increase employee’s wages above the real living wage.

Table 5.4 below outlines current national insurance contributions and an illustrative low pay levy set at 3.8 per cent.

TABLE 5.4

UK employers’ national insurance contribution rate and illustrative low pay levy (marginal tax rates)

	UK employers’ NICs	Low pay levy	Combined
£0 – £8,632	0%	3.8%	3.8%
£8,633 and above	13.8%	0%	13.8%

Source: IPPR Scotland analysis

Given the existence of a legal wage floor, through the UK-wide minimum wage, a low pay levy could be introduced while minimising the risk of increased payroll tax being passed on in lower wages for the already low-paid. Equally, a fair work bonus could increase the incentives for employers to pay the real-living wage and to provide progression towards median income. In many ways this could be an option for giving teeth to current Scottish government agendas around inclusive growth, fair work and the Scottish Business Pledge. In this sense a low pay levy and fair work bonus could have progressive effects for employees in Scotland.

A low pay levy and fair work bonus as outlined above could provide disincentives to employers adopting low pay business models, incentives to employers to adopt the real living wage, and provide additional public funds. It could also act to redistribute funds from low-pay employers to living wage employers, being at least cost neutral for those employers paying the living wage.

Increasing public revenue and behavioural change

As stated, to be able to use Scotland’s local tax powers, the revenue from any local payroll tax would need to go to fund local authority expenditure. Funding from any local payroll tax could be used to increase the local government revenue allocation as a whole (as per business rates now) or it could be retained by individual local authorities. Either way it would be a political decision as to whether new income from any local payroll tax was treated within the existing equalisation methods in place for local government, or as separate to this.

⁶ A fair work bonus of this sort could be implemented as a Scotland-wide tax allowance as with the small business bonus now.

The low pay levy/fair work bonus local payroll tax outlined above would in many ways be designed on a polluter-pays principle, in an attempt to reduce instances of low pay and encourage employers to adopt and pay the real living wage. If it were to be successful it would therefore be as much about encouraging behaviour change among employers as about increasing tax revenue.

Collection

It is likely to be most practicable to set a Scotland-wide Levy rate, as with arrangements for the business rates poundage rate set across Scotland now. This would avoid the need for employers that operate across a number of local authority areas to have to respond to up to 32 different tax rates.

The two most obvious collection routes would be through Revenue Scotland or through individual local authorities. However, neither Revenue Scotland nor local authorities currently collect income or payroll tax revenue. A new local payroll tax would therefore require new collection structures and administration.

Equally, it would be important to try to limit unnecessary administration for employers. Currently, UK national insurance contributions are collected from employers through HMRC. A data sharing agreement between HMRC, and a Scotland-based collection agency, in line with those in place between DWP and Social Security Scotland for the purposes of social security, could avoid needless red tape for businesses in Scotland.

5.3. A FAIR WORK BUSINESS RATES SUPPLEMENT

Alongside whole new local taxes there is the option of adding new elements to existing local taxes. Currently, the business rates system in Scotland is based on the property values of premises occupied by businesses in Scotland. However, further supplements could be added to business rates based on other criteria through existing local tax powers, as long as revenue went to funding local government.

A fair work business rates supplement

One option in this category would be a new fair work supplement, added to the existing business rates system in Scotland. This would see a supplementary charge added to the business rates bill of employers who do not meet fair work criteria set out by the Scottish government. Criteria could include the existence of a collective bargaining arrangement, adherence to the real-living wage and other criterion taken from existing initiatives such as the Scottish Business Pledge. This would be in keeping with the Scottish government's 'fair-work first' approach to businesses receiving government support more broadly. By adding a supplement to those employers who do not meet fair work criteria, an incentive could be introduced to increase the number of employers who do, giving an impetus to the Scottish government's fair work and inclusive growth agendas, helping to meet the government's targets and ambitions around collective bargaining, poverty and inequality.

The level of fair work supplement, for those businesses that do not meet fair work criteria, could be calculated as a proportion of profit, turnover or total payroll, and collected through the existing business rates system, bringing greater numbers of businesses into the business rates system and providing new revenues for local government.

Increasing public revenue and behavioural change

The amount of the fair work supplement could be set across Scotland or by each local authority. To be within local tax powers, tax revenue would need to go to local government funding in Scotland, whether on a pooled basis or retained locally by individual local authorities.

A fair work supplement could help to drive behaviour change among employers, encouraging those that do not currently meet Fair Work criteria to change in order to do so. Equally, it could provide increased revenue both directly, and indirectly if successful in driving higher rates of pay. If the supplement was calculated on the basis of payroll, turnover or profit (among other options), it could also broaden the tax base for business rates and the Scotland tax system in turn. As a tax on business, in direct terms it would be neither progressive nor regressive for households. However, if it successfully encourages greater numbers of employers to become fair work employers, it could have progressive effects for employees across Scotland.

Collection

Business rates are currently collected by each of the 32 local authorities in Scotland. It would therefore make sense for any fair work supplement to be likewise collected by local authorities. Successful collection would require local authorities to be able to invest in capacity to administer the new fair work supplement, taking data returns from employers and adding the supplement to employer's business rate bills. One option that may streamline collection and administration, for both businesses and local authorities, would be to calculate the fair work supplement as a proportion of an employer's tax liability for the previous year. For example, charging a proportion of a business's corporation tax obligations or national insurance contributions for the previous year, could allow a fair work supplement to be charged while minimising regulation. Equally, agreeing data sharing agreements between local authorities and HMRC could further streamline arrangements.

5.4. INCOME TAX ASSIGNATION TO LOCAL AUTHORITIES

Alongside creating whole new local taxes or new supplements, there is the option of new forms of tax assignation to help to fund local government. Given the recent devolution of income tax on earnings to the Scottish parliament, there may now be new avenues for assignation to replace some or all of the general revenue grant provided to local authorities in Scotland.

Current funding arrangements

As outlined in section 2, the general revenue grant distributed by the Scottish government to local authorities provides just under £7 billion per year for local government services in Scotland, more than half of total revenue funding. This is set through the Scottish government's budget process, meaning significant proportions of funding for local authorities are set by Scottish ministers, and agreed by the Scottish parliament, meaning local authorities can be significantly impacted by national funding priorities and political context. Indeed, in recent years, funding for local authorities has been cut by significant sums as the Scottish parliament's budget has fallen due to UK government decisions, and expensive funding pledges, for example to increase NHS funding, have been implemented. At the same time, given the lack of multi-year budget settlements at the UK and Scottish government levels, local government has been given little notice of its budgets from year to year, providing little certainty over budgets to plan spending over the medium-term.

Options for income tax assignation in Scotland

While a local income tax was one of the few options for local tax reform to have received significant consideration in Scotland since devolution in 1999, income tax assignation has received far less attention. However, since the devolution of new income tax powers to the Scottish parliament there could be new opportunities for local government funding.

For example, the devolution of tax powers has provided some level of certainty of planning into the future for the Scottish parliament. Around half of the Scottish parliament's budget will now be funded through devolved tax revenues, and the

parliament's budget will be set, in part, using multi-year projections from the Scottish Fiscal Commission from these revenue streams. While this arrangement has led to new uncertainties (in particular whether projections from the SFC will turn out to be different from outturn figures), and new risks (as spending in Scotland will in part be determined by the performance of tax revenue per head in Scotland), it should over time provide new levels of medium-term certainty as tax projections will be for the next five years, compared to previous arrangements where a block-grant for Scotland could be set year-to-year depending on Westminster spending decisions.

This opens new opportunities to pass on some of this certainty to other parts of Scotland's budget.

Income tax assignment to local authority budgets

As stated above, following the agreement between the SNP and Scottish Greens as part of the last budget process, the Scottish government has agreed to explore how three-year budgets could be provided for local government.

One option that could be considered would be income tax assignment to replace some or all of the general revenue grant. In its most basic form this could provide assignment of a set proportion of projected devolved income tax revenue to displace a proportion of the general revenue grant. On current projections, assigning around half of devolved income tax revenue to local government funding would be enough to replace all of the general revenue grant. This pooled income tax revenue could then be distributed to local authorities as agreed, including potentially on the current needs-based GAE arrangements. Revenue changes from Scottish government policy changes to Scottish income tax would not affect local authority budgets. This could enable sufficient certainty of revenue to provide three if not five-year spending settlements for local government funding. Furthermore, local authority grants would not be set by the Scottish parliament, but instead would be determined by tax revenue projections and reconciliations, as with Germany's financial framework, reducing the politics in setting the local government funding settlement.

A further option could be to assign projected *increases* in income tax revenue to individual local authority area. This could open up opportunities to incentivise local authorities to grow the income tax base. For example, assigning revenues from projected increases per head for the starter and basic income tax bands to each local authority, could provide a new inclusive growth incentive for local authorities to deliver against the Scottish government's fair work and inclusive growth agendas. If local authorities see increases in the number of workers moving from out of work or beneath the personal allowance to work paid above the personal allowance, or if they experience an increase in the number of workers who receive pay rises from low pay to median wage, they would see increases in revenue.

Increasing public funding and behaviour change

Tax assignment would not increase public revenues in Scotland. However, it may provide greater long-term certainty for local authorities, and reduce how much of local authority budgets are set by Scottish ministers. Furthermore, assigning increases in tax revenue per head from certain tax bands, such as the starter and basic rate, could offer incentives for local authorities to promote inclusive growth and fair work, achieving progressive outcomes for households in Scotland.

However, under income tax assignment, some risk in relation to poor income tax performance would also be devolved to local authorities. If Scotland saw decreased income tax revenues, some of this risk would be directly borne by local authority budgets. However, arguably, given income tax revenues make up a significant proportion of the Scottish parliament's revenue, and given, likewise, local authority spend represents a significant proportion of the Scottish

parliament's spend, this would likely simply make explicit what amounts to an implicit link between income tax performance and local government budgets as things stand now.

Equally, while current funding arrangements allow any volatility in business rates income to be evened out through adjustments to the general revenue grant, this would not be possible in the same way if it were replaced through income tax assignment. However, alternative arrangements to achieve the same outcome could include developing a buffer amount (as now with business rates now) allowing funds distributed to local authorities to be evened-out over a number of years, avoiding sharp peaks and troughs in overall funding for local authorities.

Collection and distribution

Devolved income tax is currently collected by HMRC. Rather than collecting income tax directly, the Scottish parliament's budgets are set by projections produced by the Scottish Fiscal Commission (SFC) which are reconciled with outturn data when the data is available (a few years later). The same process could be applied by the Scottish government for local government budgets, basing budgets on projections from the SFC and future reconciliations.

5.5. A LOCAL CARBON TAX

The Scottish Government has declared a 'climate change emergency' and agreed to sign up to new ambitious climate change targets, including reaching net-zero carbon emissions in Scotland by 2045 (CCC 2019). We wanted to consider an illustrative example of how Scotland's local taxation powers could be used to help, in some way, to drive the behaviour change we need to see to achieve a just transition to a net-zero economy.

Options for a carbon tax in Scotland

As long as any revenues from a local carbon tax in Scotland went to local authorities, it could potentially be introduced in Scotland through existing local tax powers.⁷

As outlined in section 3, there are a number of instances of sub-state, regional and local carbon taxes in operation internationally. Most notably, in Canada, the new federal carbon tax will see revenues assigned to provinces and territories, and builds on province level carbon taxes that were in operation prior to its introduction. Canada's carbon tax is levied on fuels at a rate set per tonne of carbon emissions. A similar structure of tax could be considered in Scotland.

A local carbon tax in Scotland, based on the Canada model, could see a Scotland-wide per tonne tax placed on the distribution of certain fuels for consumption. This rate could be set to drive behaviour change, increasing over time. As an example Canada's \$50 per tonne rate, planned for 2022, would translate to around £30 per tonne of carbon emissions in Scotland.

A local carbon tax of this sort would see a tax placed on those who import, distribute or deliver certain fuels for consumption within Scotland. As in Canada, a national rate of tax per tonne of carbon would then be translated into per litre, tonne or per kilogram tax rates for differing fuels, based on estimates of each fuel's carbon emissions. In Canada this includes fuel types such as aviation fuel, petrol, diesel, gas, coke, coal and combustible waste. In Scotland, a local carbon tax could be set to work around existing UK and Scotland taxation related to carbon emissions, such as fuel duty and air passenger duty. Therefore, the focus of a local carbon tax could be

⁷ It may be possible to introduce a Scotland-wide carbon tax through other powers in relation to the environment or other areas of legislative competence.

better targeted on coal, gas, wood and other hydrocarbons used by businesses and households for their energy needs.

As in Canada, tax rebates could be provided to households to ensure that those on the lowest incomes do not lose out unfairly through implementing a local carbon tax.

Public funding and behavioural change

Revenue from a local carbon tax in Scotland would be used to provide additional funding to local authorities. However, given the aim of the tax would be to drive the behaviour change required to contribute towards a just transition to a net-zero carbon emissions economy, it would not make sense for core public services to be funded through a local carbon tax of this sort. Therefore it would make sense for revenue from a local carbon tax to be retained by individual local authorities in addition to their core allocation of funds providing funds to local government to drive decarbonisation across households and businesses. Equally, it may be desirable to offer rebates to low income households to avoid some of the potential regressive effects of a carbon tax. Over time, as Scotland approaches its next set of targets for reducing carbon emissions, the local carbon tax could be increased, if required, to deliver the behaviour changes needed to transition to net-zero economy by 2045.

Collection

In Canada, regulations have been passed to place legal duties on those fuel companies who import, distribute or deliver fuels for consumption to register with tax authorities and provide regular tax returns to calculate and pay their carbon tax obligation. In Scotland, a similar regime could be implemented either centrally, through for example Revenue Scotland, which will collect air passenger duty once it is devolved, or for each local authority. Over time, local powers to set local carbon tax rates, above a Scotland-wide floor could be possible allowing individual local authorities to go further on carbon reduction if required.

There would be significant risks of cross-border flow of sales of some fuels to avoid carbon taxes, particularly in the border regions of Scotland. If a local carbon tax was set in Scotland without one in place in the rest of the UK, or at a high level, relative to any tax seen in the rest of the UK, then there would be risks of households travelling for some purchases, and businesses moving to other parts of the UK without the same tax obligation.

However, the scale of our ambition in developing new policies to reach our carbon emission targets will need to match the scale of the emergency we face. All opportunities for using Scotland's existing powers should be explored fully, including the option of a carbon tax in Scotland, whether through local taxation or other Scottish parliament powers.

6.

REMAINING CONSIDERATIONS AND CONCLUSIONS

The aim of this thought paper is to pose questions for discussion and illustrative ideas for debate. It has not set out to find definitive answers in relation to broadening Scotland's tax base or to fully work-up potential options for new local taxes.

Scotland's new powers over taxation have received a great deal of policy attention, including through IPPR Scotland's own work. However, the new powers bring new risks and potentially leave public funding in Scotland dependant on property and income taxation. Finding new ways to broaden Scotland's taxation system as a whole could be useful in the coming years. Scotland's older powers over local tax, looked at in this new light, could provide a route to new and innovative forms of taxation that can raise new revenue, broaden the tax base, and offer opportunities for behaviour change in pursuance of the Scottish government's key agendas such as inclusive growth and fair work.

Throughout this paper we have sought to provide some illustrative examples of new taxes that could be introduced in Scotland using local tax powers. In many ways, these are based on examples of sub-state taxes found internationally. However, further work would be required to cost these potential taxes and to fully consider collection and compliance issues.

The legislative blocks in the way of new local taxes in Scotland seem few, given the wide-ranging powers already devolved to the Scottish parliament in relation to local taxation. Instead, blocks to progress are likely to be in relation to collection, compliance and political support.

Equally, while using local tax powers to implement new forms of taxation in Scotland requires that the revenue goes to fund local government, there are a number of political decisions as to who ultimately benefits from this revenue. Additional revenue could be retained by individual local authorities or pooled to fund local government as a whole. Alternatively, new revenue from local taxes, or new tax assignment, could be used to free-up some or all of the core grants provided to local authorities each year by the Scottish government. Whether individual local authorities, local government funding as a whole, or Scottish government budgets benefits from new local tax revenue is ultimately a political decision.

Local tax has in many ways been a policy area 'too hot to handle' for every Scottish government since devolution, with the bar for success being set very high. Attempting to find a single new tax to wholly replace council tax or business rates, both taxes worth over £2 billion per year, and to gain sufficient political support to do so, all the while sustaining political support through opposition from those that lose out under any change, will always be difficult. However, in looking at how local tax powers in Scotland could be used to broaden the mix of taxation in Scotland as a whole potentially lowers the bar considerably.

This is the fundamental approach of this thought paper. In many ways this is in keeping with the message from the series of reviews of local tax we have seen in Scotland, including the Local Tax Commission, which recommended a number of local taxes rather than one single tax. The illustrative examples in this thought paper are therefore designed as examples of what could be done in Scotland to the side of any council tax or business rates system (whether reformed or unreformed), and as such we hope they can stimulate discussion, debate and important decisions that can lead to progress more quickly than the quarter of a century we have seen pass waiting for significant reform to local taxation in Scotland so far.

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