GREY HAIRS
THE EXPERIENCED CONSULTANTS

Making Local Income Tax Work

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Disclaimer: *Although this document is published under the auspices of Isitfair, it does not necessarily represent Isitfair's views or policies with regard to flat taxes.*

Isitfair is an organisation campaigning for the reform of the Council Tax. As such it recognises that this will only be practicable if alternative sources of funding can be identified. Flat taxes are merely one of the many options that have been investigated as possible alternative sources of funding. This document is one of a series of documents illustrating the depth of Isitfair's thinking about these alternative sources

Since Isitfair is not a political party in the conventional sense, it believes that it would be dishonest to "smuggle in" any tax changes that are not essential to its aim of reforming Council Tax. In particular we believe that any change to the regressiveness or progressiveness of the overall taxation system is an entirely separate matter that ought to be debated separately. Since the introduction of flat taxes would impact on the progressiveness of the current tax system, flat taxes do not form part of Isitfair's proposed solution at the present time.

1. INTRODUCTION

Local Authorities in England are funded by a combination of charges for services, Council Tax and Grants from Central Government. However, the Council Tax is widely seen to be "unfair". There are a number of reasons for this perception, (discussed in section 3). These are mainly linked to issues relating to perceived "ability to pay", (discussed in section 2). It is widely felt that a "fairer" system would involve taxes being more directly related to people's incomes and / or their spending. Clearly, the easiest way to achieve this would to replace Council Tax altogether by some combination of income and / or sales taxes. Indeed Isitfair has proposed that Council Tax should be abolished and that Local Authorities should be funded by increases to **national** Income Tax and **national** VAT. The details of this proposal are described in the document: "*Local Authority Funding - A Fairer Tax Raising System*", (written for Isitfair by the author of the current document).

However, many of the published submissions to the Lyons Inquiry have proposed that Council Tax should either be replaced by, or supplemented by, **Local** Income Taxes, (LIT), and **Local** Sales Taxes, (LST). I discuss what I mean by "local" taxes in section 4. Most of the objections to these proposals, (discussed in section 5), that have been raised concern economic or administrative issues. None, so far as I am aware, have been raised on the grounds that such taxes would be "unfair".

This document describes, (in section 6), how the most awkward of the administrative problems associated with LIT could be overcome.

2. WHAT IS ABILITY TO PAY?

In the final analysis there are only three ways in which people can pay monetary taxes: they can pay them out of their **incomes**; they can pay them out of their **wealth** / savings; or they can pay them out of **credit** / borrowings. Since a person's credit-worthiness is largely determined by their incomes, (or, to be more accurate, their expectation of future income), and / or their assets, payment of taxes out of borrowings is more of a **mechanism** for payment rather than a determinant of actual ability to pay.

Once a person has met their minimum subsistence needs, it could reasonably be argued that they are **capable** of paying taxes at any rate up to 100% on any further income, wealth or credit that they may have. Since, (I believe), the overwhelming majority of the electorate would object to anything like this actually happening in practice, it is clear that pure "ability to pay" should **never** be the main reason, (or excuse), for imposing any particular tax whatever. On the other hand perhaps, genuine "inability to pay" should always be a valid excuse for **not** being required to pay particular taxes. It follows that it is only valid to use "ability to pay" as an argument in favour of a particular taxation regime when the amount of tax that needs to be raised is so high that serious questions about other people's ability or inability to pay them would be raised. Unless this situation applies, then, logically, the common view that "the rich should pay more" needs to be justified on completely different grounds.

When most people use the phrase “ability to pay” they usually mean that actual payment would not cause “undue hardship”. Different people’s perceptions of undue hardship differ, but most people would regard the **absence** of a mere subsistence level of means as an unduly harsh criterion when judging “ability to pay”. It would seem to me that the popular, informal, “gut feeling” definition of hardship is when somebody is unable to procure **most**, (but not all), of the sorts of things that **most**, (but not all), “ordinary” people can enjoy. This definition is obviously closely related to some fraction of **median** income, (though not necessarily the 60% of median income that many statisticians and government bodies, both in the UK and overseas, use as an indicator of **relative** poverty).

It would appear that many people regard **income** as the **sole** determinant of ability to pay. Clearly it is an important one. However, it is worth remarking that many people’s incomes, even those which are relatively high, are often close to being fully committed, (on mortgages, school fees and the like). This provides a good argument against any **sudden** or **large upward changes** in taxes on income. More gradual increases can probably be accommodated. Shifting the burden of all other taxes, or indeed any high yielding tax, solely onto income would only seem to be sensible, if ever, in the very long term. On the other hand, income tax at the existing levels is obviously “affordable” - people do, (in general), actually manage to pay their income taxes.

The argument which we have heard most often against basing any taxation on wealth is that the wealth concerned has already been taxed as income. This has nothing to do with “affordability” and, indeed, it is not always true. Whether or not a person can afford to pay taxes on the basis of their wealth depends, in part, upon the nature of that wealth. For example, according to the Office for National Statistics, (http://www.statistics.gov.uk/cci/nugget.asp?id=2):

“Wealth is considerably less evenly distributed than income, and life cycle effects mean that this will almost always be so. People build up assets during the course of their working lives and then draw them down during the years of retirement, with the residue passing to others at their death.”

From the standpoint of “affordability”, it would seem that people who draw down their savings to support whatever lifestyle they may have are in much the same position as people who are drawing an income of an equivalent amount. Indeed, on **average**, they would enjoy much the same income if they were to use their savings to purchase an annuity. There seems to be no case in terms of either “fairness” or “affordability” to treat savings any differently from income in this respect. However, the situation is somewhat different for those who are still building up savings for their old age. Can such people really “afford” to pay taxes on these savings? In immediate terms they obviously can, but does it make sense to, in effect, tax them in advance on a basis that, when the time comes, they would no longer be able to afford?

Apart from this particular exception, (which could always, at least in **principle**, be dealt with by making wealth held in pension funds exempt), one can always "afford" to pay taxes out of one's wealth. Whether or not this is "fair" and whether or not governments would be **wise** to impose wealth taxes are completely different issues. The main **practical** problem of any wealth tax lies in the questions of **liquidity** and **divisibility**. Not all forms of wealth are easily converted into money, (at least rapidly and cheaply), and not all wealth is easily divisible - real estate being an obvious example in both cases. However, this does not preclude the use of **credit** or deferred taxation as a way of implementing a tax on wealth. Once again, whether it would be sensible or "fair" to force people to take out loans in order to pay their taxes is a different question altogether.

The conclusions from the above arguments are that either wealth and / or income could be used to assess the "affordability" of any tax. However, this does not mean that the Council Tax, in its existing form, is always "affordable"

3. WHAT IS FAIRNESS?

"Fairness" is, by its very nature, something that is subjective and difficult to define objectively. However, the claim that the Council Tax is "unfair" can be justified on several grounds.

- Most people would regard one of the criteria of "fairness" as being a situation in which people in broadly similar financial circumstances pay broadly similar amounts in tax. The Council Tax does not meet this particular criterion.

  — Council Tax is supposed to be based on the likely sale value of any property. The amount payable takes no account of whether the property is tenanted or whether it is mortgaged. Other things being equal, those who own their properties outright are in a better financial situation than those occupying property that is still subject to a mortgage and such people, if they own **any** equity at all in their houses are in turn in a better financial position than tenants.

- Another criterion for "fairness" which is likely to meet with almost universal agreement is that people who have a greater ability to pay tax should not pay less in tax than those whose ability to pay is lower. The Council Tax does not meet this criterion either.

  — One of the systemic failures of the Council Tax system is that, on average, it forces the "middling poor" in the "richer" areas to subsidise the "middling rich" living in the "poorer" areas. The "middling poor" in the South East, the South West and the Eastern Local Government Office Regions all pay more in Council Tax than their incomes would warrant when compared with the "middling rich" in other Regions. In a similar way, people living in the Shire Districts lose out to people living in the Unitary Councils who in turn lose out to people in the Metropolitan ones. This contention is fully backed by two completely different sets of detailed statistical analysis.

- A third criterion for "fairness" with which most people would agree is that people who receive better services from their Local Authority should, in general, pay more tax than those who do not receive such good services. The Council Tax fails the "fairness" test on this criterion as well. If we examine the correlation between Local Authority spending per head and the Council Tax per head for each authority we find that we get a **negative** relationship. To be sure, greater spending does not always equal better services, but unless there is a **tendency** in that direction, then spending by Local Authorities ought to cease altogether!

4. WHAT ARE LOCAL TAXES?

Before proposing the imposition of a "Local" Income Tax, it is important to be clear what actually constitutes **true local** taxation. I would suggest that true local taxation has to fulfil the following criteria:

- The **amount** of any "local" tax that an individual taxpayer has to pay is decided purely locally - that is by the Local Authority raising the tax.

- The entire **yield** from any "local" tax is spent locally on things that are decided locally - again by the Local Authority imposing the tax

- There is a **direct** relationship between the local tax imposed by any Local Authority and the money that it has available to spend on its own priorities. If Central Government grants are used to "equalise resources" so that Local Authorities have to spend "local" taxes on things decided by Central Government then we really have a **national** tax masquerading as a local tax

— The Council Tax, which was originally more of a true local tax, has, in effect become a national tax because some Local Authorities receive grants from Central Government part of which they can spend as they themselves think fit whereas other Local Authorities are required to spend some of the Council Tax yield on things decided by Central Government and not by themselves.

5. CONVENTIONAL LIT - ARGUMENTS FOR AND AGAINST

For most people, a Local Income Tax would be a tax levied on the total income of each person resident in a given Local Authority area with the **rate** at which this tax is levied being decided locally by the Local Authority concerned.

The strongest argument in favour of a Local Income Tax of this sort is that such a tax would, like national income tax, obviously be directly linked to ability to pay. Whether used as a supplement to, or as a partial or total replacement for, the council tax, there is little doubt that a Local Income Tax would enable the overall burden of "local" taxes to be more closely related to people's incomes. However, it is worth remarking that using local income tax purely as a **supplement**, (in order to increase the proportion of local expenditure that is funded locally), would do absolutely nothing towards removing what some people see as the "unfairness" associated with the Council Tax. Only if Local Income Taxes were to be used as a partial or total **replacement** for some or all of the revenue currently collected through the Council Tax would the problems of "unfairness" be alleviated.

Unfortunately, for many of its adherents, Local Income Tax is seen as one of the more promising ways of raising **additional** funding. It is not (generally), seen as a **substitute** for Council Tax

The main argument against a **Local** Income Tax is one of the cost of collection and administration. **National** income taxes are levied at **uniform** rates and allowances for each band of income and most of the cost of administration is borne by employers through the PAYE system. These employers will usually have computerised payroll systems which are unlikely to be flexible enough to deal with a whole range of **different** rates, (in theory up to 354 different rates for each band of income - and possibly 354 different break points for the different bands of income within England alone!). Moreover this same multiplicity of rates would probably also apply to investment and other sources of income besides pay and pensions, (and many pensioners have more than one source of pension!). At present only a minority of people have to complete self assessment forms - all of which have to be checked by Inland Revenue staff. With the type of Local Income Tax described above, virtually everybody would be required to complete such self assessment forms and many more tax office staff would be required to deal with them.

Of course, if the rates of tax and the breakpoints were to be uniform, many of these extra costs would not be incurred - but then we would not have a Local Income Tax. We would merely have a **national** income tax masquerading as a local one! In fact I suspect that rates would become **almost** but **not quite** uniform - which is probably the worst of all possible worlds. It is almost inevitable that central government will feel constrained to provide extra national funding for those local authorities that have lower taxable capacities than others. It is obvious that, under such circumstances, any "local" income tax which merely supplemented **national** funding of local government would very rapidly become merely another, more bureaucratic, **national** income tax, (unless the equivalent of "Resource Equalisation" were to be abandoned - which seems to be unlikely / "unfair").

I would regard this as a particularly severe drawback to this (conventional) type of Local Income Tax. I am particularly concerned that the Balance of Funding Review calculations concerning the probable cost of implementing a Local Income Tax of this nature seem to ignore the administrative points raised above. I also note that the cost of national income tax collection only **looks** small because the total amounts collected are so large. If the national rate were only one penny in the pound then the **absolute** costs of collection would remain much the same as now - but the **proportion** of tax collected that would disappear in administration costs would then look horrendous. Even if only existing basic and higher rate tax payers were to pay a "local" income tax, the average rate required to achieve the same **net** yield as the Council Tax would only be around 5.7p in the pound. If all those who currently paid any income tax contributed, the rate would fall to 3.9p in the pound, and would fall even further if everybody contributed. On the other hand, as I argue in the Isitfair document: "*Local Authority Funding - A Fairer Tax Raising System*", we would probably need to raise somewhat more than the **net** yield from Council Tax in order to fund the abolition of Council Tax Benefit that would occur if Council Tax were to be abolished. If we take £25 Bn as the total amount that has to be raised to replace Council Tax and Council Tax Benefit by LIT, we would need a basic local rate of 6.8p in the pound, (if we were to leave all other rates and allowances unchanged). However, whichever scenario and rate one chooses, it is clear that the administration costs as a proportion of the tax collected would simply be too large to be sensible.

Another strong argument against this conventional form of a Local Income Tax , (and against Local Sales Taxes), concerns the issue of **displacement**. This is an issue of economics and tax avoidance / tax evasion. Whether this displacement is **real**, or whether it merely happens "on paper" is immaterial. For example, in the case of Local Income Taxes payable to the Local Authority in which the tax payer resides, what is to stop a person with a large income from registering his residence in whatever Local Authority charges the lowest tax rates, (while presumably no longer "officially" cohabiting with an ("officially") penniless partner who continues to reside where both **really** live)?

Indeed, what is to stop a Local Authority from adopting the Channel Islands or Isle of Man strategy and deliberately encouraging the wealthy to live there, (on paper)? Low taxes charged to wealthy outsiders would raise very substantial revenues to the benefit of truly local residents! Local Income Taxes would appear to encourage beggar my neighbour policies. This might well lead to lower taxation overall, but it would also tend to lead to a decline in public services.

6. POSSIBLE SOLUTIONS TO THE PROBLEM

I believe that the way to solve all the problems outlined in the previous section is not to have any local setting of income tax **rates** at all. Instead, the Local Authority could be given the right to determine the size of the **personal allowance** that each of its residents receives. This should not cause much in the way of significant problems to computerised payroll systems because all such systems currently have to cope with a wide range of **tax codings** - which are essentially a way of determining what the effective personal allowance of each individual taxpayer should be.

Such a system would work as follows:

- First the basic rate of tax collected **nationally** would be raised to whatever level was required to fund the degree to which Council Tax was to be replaced by LIT. If we take the full abolition of Council Tax and the £25Bn or so of extra funding this would require to be raised through income tax, this would make the basic rate of income tax 28.8p, (figures are for 2005/06 and it is assumed that the **gaps** between any personal allowance, basic / reduced rate thresholds and basic / higher rate thresholds remain the same).

- Second, the **national** personal allowance would be raised so that the **national** yield from income tax would remain the same. In the case of the extra 6.8p in the pound needed to raise the extra £25Bn to abolish Council Tax altogether, personal allowances would have to be raised from £4,895 to £8,275, (again figures are for 2005/06). This would provide the "headroom" for Local Authorities to set lower rates of personal allowance so as to raise revenue for local purposes.

- Third, all income tax would be collected **centrally** as at present. Local Authorities would receive a per capita amount back. The share that each Local Authority would receive back of the **additional** amount that is **actually** collected would be in proportion to the amount that **would have been** collected per capita **nationally** if their particular personal allowance had been applied **uniformly** across the nation.

    — For example, if the **national** average personal allowance were to be £5,000 with a basic tax rate of 28.8%, then the total national yield from the "local" portion of the income tax would be

£24.26Bn. However, if the Local Authority were to set its own personal allowance at £4,500, then the national average collection for such a rate would be £28.14Bn. The Local Authority setting this rate would therefore receive a per capita allowance of 15.9% more than the national average, (figures are approximate).

This "unconventional" system offers several advantages over the more "conventional" system described in the previous section.

- First, unlike the case with the more conventional type of LIT, the administrative cost of operating our less conventional form of LIT is unlikely to be significantly more than that involved in operating the current national income tax system. It is certainly likely to be lower than the (over-optimistic) estimates administrative costs of LIT contained within the Balance of Funding Review and less than the administrative costs of operating the current Council Tax system.

- Second, there is no incentive for any Local Authority to set artificially high personal allowances, (equivalent to low rates of tax). The amount a Local Authority receives is independent of the actual incomes of its residents. The Isle of Man / Channel Islands strategy simply does not work.

- Third, and because of the above, there is an implicit resource equalisation which can not be manipulated by Central Government, (unlike the present Council Tax system which **could** be - but may **not actually** be). Local Authorities are not penalised for having many residents on lower than average incomes.

- Fourth, there will be little incentive for tax displacement activities. Since no Local Authority gains from being over generous or over mean, (high spending Local Authorities **always** have to charge their residents higher taxes - and they will vote them out if the improved services are not good value for money), personal allowances are not likely to be sufficiently different to encourage people to "lie" about where they live or to move elsewhere. The differences in their overall tax bills depending upon which Local Authority they pay their taxes to are likely to be too small to be worth the trouble.

    — No Local Authority can curry favour with one section of its electorate at the expense of another.

7. CONCLUDING REMARKS

Nothing in this paper represents a genuine **proposal**. The aim of this work is to indicate what is **possible**. For example, it would be possible to adopt the main Isitfair proposal for increases to both income tax and VAT contained in: "*Local Authority Funding - A Fairer Tax Raising System*" by converting only the national income tax element of that proposal into a LIT.

It is a sad fact of life that LIT tends to be favoured mainly by those who believe that overall, the tax system should be somewhat more progressive than it is currently. I wish to make no comment on this matter other than to note that it would be more honest to make the case for more progressive, (or less progressive) taxes **directly** and not use changes to the system devised for other purposes to "smuggle in" any such changes.

Actually, although the “unconventional” from of LIT described above is slightly more progressive than the Council Tax at the bottom end of the income distribution, it, like the Council Tax, has an implicit upper limit on the amount of LIT that any one person can be required to pay. This is because we are not allowing for any increase to the upper rate of income tax. While some people might consider this “unfair”, (and is indeed not an essential feature of this form of LIT), it is worth remarking that higher rate tax payers will still be paying more (than they do now) by way of basic rate tax than those whose incomes lie below the higher rate tax threshold.

Many of those who oppose LIT seem to do so out of fear that any new taxes or changes to the system will be used mainly as a way of increasing the overall tax burden on taxpayers. Once again, I would argue that the case for any changes to the overall tax burden should be made directly and not “smuggled in” as part of other changes.

A possible remaining problem is that it is not clear **which** local authority should receive the money from any LIT, the one in which the money was earned or the one in which the earner resides? One can adduce plausible arguments for both, (although I assume in this paper it is residence that counts). If the tax is payable where the income was created, then another form of displacement becomes a problem. Although it is relatively easy to determine where the typical worker on a factory assembly line earns his money, it is much harder to determine where knowledge workers do. In the extreme case a management consultant might earn all his money (in different countries) abroad, yet still live in the UK. Pensioners, of course, do not (now) “earn” their money anywhere! Similar remarks apply to investment income. For this reason it would seem to be better to leave this particular can of worms unopened!