Institute for Public Policy Research

# THINKING BIGGER ON TAX IN SCOTLAND
## USING SCOTLAND'S LOCAL TAX POWERS TO THEIR FULL POTENTIAL

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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.

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