FINANCING AND TAXING FOR LOCAL GOVERNMENT

Kenneth Gibb and Linda Christie

Introduction

Over time and in most places, the key source of dispute between local and central government usually centres on finance. How much is local government spending, what it is doing to household tax burdens, to what extent are key financial decisions relatively autonomously determined by local government and to what extent are they centralised to higher level tiers of government? As we shall see, there are idiosyncratic and path dependent reasons why different systems of government achieve different local government finance system outcomes. Gallagher et al. (2007) argue that we need to think of local government across multiple dimensions – finance, the allocation of services between different tiers of government and the functional geography of local government. All interact and when central government chooses to reform local government, it normally does so without taking account of the knock-on effects on the other dimensions, which sometimes don’t become apparent for years. We explore these interdependencies further in the next section.

In this chapter we argue that a critical element in the wider finance debate is the form of local tax adopted and how it interacts with other forms of finance available to local government. As we shall see, most countries use a mix of property and income taxes to fund a proportion of the cost of local government services but they vary hugely in terms of how they operate and the ways in which specific systems of local government finance adjust them to reduce their perceived political cost. A second theme of this chapter is to make explicit this sense, that local taxes, especially on property, are not as legitimate in the eyes of taxpayers as are some other taxes. This appears to be a sufficient to change the behaviour of government considering local taxes and in particular to constrain their willingness to pursue meaningful reform. In the United Kingdom (and in other states), this has been most clearly shown by the long term and continuing unwillingness to undertake regular revaluations of properties.

This chapter draws extensively on an earlier review of international evidence of property and other forms of the taxation of local government (Gibb and Christie 2015 – written for the recent Scottish Commission on Local Tax Reform), and also from chapters on local government finance by the same authors in Gibb and Christie (2016) and Gibb et al. (2017). The current chapter begins with a brief in-principle account of the key interconnections found between finance and the structure of local government and its critical fiscal and service interconnections.
with higher levels of government. We then look at Organisation of Economic Co-operation and Development (OECD) data that suggests considerable variety in financing, local autonomy and taxation models internationally. The third main section of the chapter pulls together the main messages from an international review of local taxation. The paper then turns to the highly salient question of property tax reform, its drivers, challenges and possible ways forward. The fifth section is a case study of recent efforts to reform local taxes in Scotland before a short concluding section.

**Financing and taxing in local government: general considerations**

Different national systems of local government vary hugely around the developed world for historical, political and institutional reasons. Nonetheless, there are a number of common high-level features that apply universally, regardless of whether we are talking about a federal system or a unitary model of government. We outline these strands briefly before turning to national and comparative evidence.

The functional division of public services between national, state and local government is critical. In particular, some countries provide welfare state type services through local government and that may make them more likely to adopt income taxation to pay for them (Hollis et al. 1992). Countries which are more oriented to the provision of amenity and facility type services locally are often more likely to use an element of ‘beneficial’ taxes such as those based on property (i.e. house values respond to and capitalise beneficial public services so that would on the face of it make an argument for a property-based tax).

The distribution vertically of services is also part of the reasoning behind intergovernmental grants – if local government delivers nationally-driven basic education, then intergovernmental grants may help fund the programme, and this is also the case for the support of other national priorities delivered locally such as emergency services (often called specific grants).

In countries like the UK, the grant system operates in large part as a ‘block’ and can be used to control and direct local government spending for macroeconomic as well as political reasons. Grant adjustment has implications for local tax levels and the freedom local government has to set and adjust its tax rates. More generally, one can distinguish three types of grant – specific grants tied to a function (as discussed above), grants that compensate for different levels of need across a country (e.g. because of the age distribution locally, different levels of spatial deprivation or economic activity, etc.), and grants that equalise uneven resource or tax bases so that income and therefore expenditure can itself be more consistent across local governments who would otherwise have very different resources and hence require wildly different tax rates to achieve the same spend per head. This also connects to in-principle ideas that local taxation should be as neutral as possible across space, other than through the explicit discretion of local governments who seek to have different tax rates because in some way that reflects local preferences. The grant system is also one way that governments facing fiscal pressures may transfer cuts or resource reductions down the way to local government rather than choosing to cut back national services.

This all means that the choice of local taxes, and willingness to reform them, is not simply a local political question but speaks instead to the wider system of governance in a nation and specifically about the intergovernmental relations, power, treasure and ideology that pertains to different tiers (and of course may often represent different political aspirations and parties). ‘Fixing’ local government’s taxation (e.g. an unpopular tax that is blamed on the national as opposed to the local government) may actually be a multi-level problem associated with those intergovernmental relations, the distribution of powers between different tiers, the interaction of the grant and
Financing and taxing for local government

tax system, the geography of local government (and whether administrative boundaries roughly
equate to functional economic geography), as well as the actual taxes being adopted. These factors
help explain why inertia may fatally inhibit credible reform in this arena.

**OECD analysis of local taxes and sub-central tax autonomy**

Table 31.1 summarises the distribution of local taxes across the OECD members in 2010 (Slack
and Bird 2014).

<table>
<thead>
<tr>
<th>Country</th>
<th>Property</th>
<th>Income*</th>
<th>Goods and services</th>
<th>Other**</th>
<th>Local taxes as % of local expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>100</td>
<td>0</td>
<td>0</td>
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</tr>
<tr>
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<td>13</td>
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<tr>
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<td>53</td>
<td>37</td>
<td>10</td>
<td>0</td>
<td>32</td>
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<td>Canada</td>
<td>91</td>
<td>0</td>
<td>2</td>
<td>7</td>
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<td>Chile</td>
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<td>Czech</td>
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<td>48</td>
<td>0</td>
<td>40</td>
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<td>Denmark</td>
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<td>89</td>
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<td>0</td>
<td>34</td>
</tr>
<tr>
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<td>8</td>
<td>90</td>
<td>3</td>
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<td>45</td>
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<tr>
<td>Finland</td>
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<td>94</td>
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<td>0</td>
<td>46</td>
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<tr>
<td>France</td>
<td>54</td>
<td>8</td>
<td>25</td>
<td>12</td>
<td>39</td>
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<tr>
<td>Germany</td>
<td>16</td>
<td>78</td>
<td>6</td>
<td>0</td>
<td>36</td>
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<tr>
<td>Greece</td>
<td>24</td>
<td>0</td>
<td>21</td>
<td>55</td>
<td>12</td>
</tr>
<tr>
<td>Hungary</td>
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<td>80</td>
<td>6</td>
<td>19</td>
</tr>
<tr>
<td>Iceland</td>
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<td>77</td>
<td>2</td>
<td>0</td>
<td>67</td>
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<tr>
<td>Ireland</td>
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<td>0</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Israel</td>
<td>95</td>
<td>0</td>
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<td>0</td>
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<tr>
<td>Italy</td>
<td>9</td>
<td>25</td>
<td>33</td>
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<td>41</td>
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<tr>
<td>Japan</td>
<td>30</td>
<td>49</td>
<td>19</td>
<td>2</td>
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<tr>
<td>Korea</td>
<td>16</td>
<td>17</td>
<td>27</td>
<td>40</td>
<td>n.a.</td>
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<tr>
<td>Luxembourg</td>
<td>4</td>
<td>92</td>
<td>1</td>
<td>2</td>
<td>31</td>
</tr>
<tr>
<td>Mexico</td>
<td>59</td>
<td>0</td>
<td>2</td>
<td>39</td>
<td>n.a.</td>
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<tr>
<td>Netherlands</td>
<td>48</td>
<td>0</td>
<td>50</td>
<td>2</td>
<td>9</td>
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<tr>
<td>New Zealand</td>
<td>91</td>
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<td>9</td>
<td>0</td>
<td>n.a.</td>
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<tr>
<td>Norway</td>
<td>5</td>
<td>88</td>
<td>1</td>
<td>5</td>
<td>38</td>
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<tr>
<td>Poland</td>
<td>29</td>
<td>58</td>
<td>8</td>
<td>4</td>
<td>27</td>
</tr>
<tr>
<td>Portugal</td>
<td>34</td>
<td>35</td>
<td>26</td>
<td>5</td>
<td>25</td>
</tr>
<tr>
<td>Slovak</td>
<td>51</td>
<td>0</td>
<td>49</td>
<td>0</td>
<td>11</td>
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<tr>
<td>Slovenia</td>
<td>12</td>
<td>78</td>
<td>6</td>
<td>3</td>
<td>40</td>
</tr>
<tr>
<td>Spain</td>
<td>30</td>
<td>21</td>
<td>39</td>
<td>11</td>
<td>42</td>
</tr>
<tr>
<td>Sweden</td>
<td>3</td>
<td>97</td>
<td>0</td>
<td>0</td>
<td>64</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1</td>
<td>84</td>
<td>1</td>
<td>13</td>
<td>58</td>
</tr>
<tr>
<td>Turkey</td>
<td>11</td>
<td>24</td>
<td>50</td>
<td>14</td>
<td>n.a.</td>
</tr>
<tr>
<td>United States</td>
<td>73</td>
<td>5</td>
<td>21</td>
<td>0</td>
<td>n.a.</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td><strong>100</strong></td>
<td><strong>0</strong></td>
<td><strong>0</strong></td>
<td><strong>0</strong></td>
<td><strong>12.6</strong></td>
</tr>
</tbody>
</table>

Source: Adapted from Slack and Bird (2014: table A2, p. 29)

*includes income and payroll taxes; **includes social security contributions, other property-related taxes 
and other taxes. All figures rounded and may not sum to 100%
Six of the countries rely on property taxes for nine-tenths or more of their local tax revenue (including the UK, Australia, Ireland and Canada). At the same time, ten rely on income taxes for at least three-quarters of their local tax revenue (including the Scandinavian group, Denmark, Germany, Iceland, Luxembourg, Slovenia and Switzerland), though the table does not show the extent to which this incorporates a degree of tax sharing with nationally-derived income taxation. Six countries rely on taxes on goods and services to support at least 48% of local tax revenues (Slovakia, Turkey, Chile, Czech, Hungary and, surprisingly, the Netherlands). Only Greece relies on ‘other taxes’ to raise 50% or more of its local tax revenue. The UK, Ireland and Australia have just one tax raising all local tax, though it is the case that Sweden, Luxembourg, Israel and Finland all have one tax raising more than 90% of their local tax revenues. On the other hand, twenty countries operate a diverse system with at least two taxes where the smaller contribution is at least 20%.

Blochliger and Nettley (2015) consider the degree of local autonomy or what they call sub-central tax autonomy enjoyed by State and local governments in the OECD (based on 2011 data). For reference, ten of the 34 member states have either: provincial state, regional or Lander governments as well as local government. The authors define tax autonomy in terms of the extent of freedom of lower tiers of government over tax policy in their jurisdiction with special attention given to the specifics of tax-sharing arrangements (which is sometimes difficult to isolate and to contrast from intergovernmental grants).

Blochigler and Nettley also compare change to this degree of autonomy or decentralisation over time, from 1995 to 2011 (though note that OECD membership expanded considerably over this period). The authors report that the share of taxes allocated to the sub-central level actually increased from 13.5% to 15.5% and where tax base and rate-setting was relatively more decentralised, the share of autonomous local tax revenue also increased. The frequency of constitutional rules that maintained relatively more centralised power over local finance also fell. This process of decentralisation was argued to be more marked at the higher sub-national levels of State/Region/Lander level; whereas lower tier local government was more stable in terms of degree of autonomy. This is in strong contrast to the narrowing of autonomy of local government functions and finance in countries like the UK since the end of the 1970s.

**Incidence**

An important question in matters of local taxation concerns the incidence of local taxes (i.e. who does it fall on and can it reasonably be described as progressive?). While the incidence of a local income tax is straightforward (it can be measured directly as a percentage of current income), this is not so for the property tax. This is because there are several quite different perspectives as to the meaning of how local property taxes work and therefore how they impact on people in distributional terms (Bird and Slack 2004):

- As a tax on the consumption of housing services, it is regressive because housing generally constitutes a relatively larger share of consumption by poor people. This perspective is a driver of much property tax reform (e.g. the desire to redesign taxes to be more progressive in terms of current incomes and to protect the asset-rich but cash-poor household).
- As a tax on capital (in the form of housing wealth), it is essentially progressive since ownership of capital as a rule is relatively concentrated within higher income groups. The failure to tax this wealth appropriately may also impair the economy’s potential in that light or advantageous taxation leads to incentives to tie up potentially productive wealth in predominantly unproductive second-hand housing.
Other commentators believe that tax falling on land is in effect paid out of economic rents and that thus it is inherently just or fair to tax such unearned increments arising from public actions. Again, it is argued that failure to levy such a land value or site value tax prevents an opportunity to promote the more efficient allocative use of land.

Slack and Bird (2014) argue that thinking about incidence in terms of tax reform involving property taxation is inherently problematic because we are dealing with the distributional effects of a largely capitalised tax\(^1\) on a particular form of wealth and, in addition, property prices are lower than they would be in the absence of the property tax.

### Key messages from comparative research

In this section, we draw on an international review of local taxation carried out by the authors (Gibb and Christie 2016) for the recent Scottish local tax commission. Seven broad points are made.

First, both property and income-based systems of local taxation vary considerably across the OECD in terms of key features of their design:

- The nature of the tax base and its assessment. Typically, property tax bases are developed based either on rental values, capital values, land values only or area-based measures. (Almost) all are generally required to have some form of regular general revaluation process built-in as well as a system for enforcement and appeal.
- The extent that local governments are free to set tax rates annually. Most countries adopt some form of central influence or control over the size of increase, perhaps through indices link to cost of living or other rules. However, Slack and Bird (2014) suggest that across OECD, on average, local governments only have discretion over about a sixth of their property tax revenues.
- The appropriate balance between local autonomy and higher-level influence or control through tax and grant sharing to achieve national policy objectives or to assist with resource or need equalisation (i.e. national equity issues at a local level to reduce variations in spending need or the local tax base). A wider important conclusion is that, in practice, it is not realistic to wholly separate local tax from the wider system of local government finance or indeed from the tax burden as a whole.

Second, while recurrent local land and property taxes do evidently vary, key features reappear in different countries, including why specific nations favour them. Almy (2013) contends that the principal generic arguments for a property tax are that:

1. they are hard to avoid or ‘flee’;
2. local government services are provided to occupiers/owners;
3. the tax captures some of the uplift in land values following public investment;
4. as a dedicated source of revenue, the property tax provides a degree of local autonomy [true of \(\text{any}\) genuinely local tax];
5. the high visibility of property taxation provides accountability and transparency; and
6. land registration/cadastral systems have wider value and can support the general functioning of property markets.

Blochliger (2015), in addition, points to econometric analysis that property taxes can play a small but significant role in reducing house price volatility. They can also underpin sustainable land
use via land valuation taxes by helping to constrain urban sprawl and promoting the development of brown field sites.

However, these positive elements also contain the source of generic problems for property taxation as a source of local revenue (Blochliger 2015). Almy (2013) stresses that property taxes are under-utilised as a source of revenue despite their positive economic merit. The property tax is what Enid Slack calls a presumptive tax – it is widely felt by taxpayers to be one imposed on them and its visibility, perceived regressive unfairness and frequent valuation disagreement leads to unpopularity with citizens and politicians. Almy argues that this in turns leads to ‘legislative neglect’, or the relative unwillingness of legislators and governments to actively renew, update and maintain the property tax in terms of revaluation, tax rate setting and the relationship with the wider local government finance system. The concept of presumption and its political consequences are integral to any discussion of the barriers to tax reform involving property taxes.

Third, governments respond to this heightened saliency of property taxes by using a battery of policies designed to ameliorate the perceived unpopularity of property taxes (on the basis of the arguments above). Many of these adjustments have re-distributional and other (arguably) unintended or cumulative consequences. These include:

- Banding, as in the case of the UK council tax, though in principle the weights chosen between each band could be organised in different ways (see discussion of Council Tax reform below).
- Capping tax bills (i.e. putting a ceiling on how much they can increase) is a common way to reduce the cost of living effects of annual increases. This may involve real or nominal freezes, other limits to increases, with more or less discretion for local government within such systems. There are also examples of constitutionally-binding limits on tax bill increases such as Proposition 13 in California.
- Property tax reliefs and exemptions are widely used internationally but are everywhere different in their specifics. Many types of property or land uses have exemptions or other concessions, as do household circumstances in some countries. At the same time, property tax in either (or both) the domestic and non-domestic settings may be allowable for tax deductibility.
- As an attempt to address the well-known cash-poor, asset-rich problem, deferrals, rebates and abatements are widely used, again varying in their national specifics. Deferring payments have been widely available in different forms in Denmark, France, Germany, the Netherlands, Spain, Sweden, parts of the United States and Northern Ireland (Almy 2013), usually deferring till the point of sale or as a lien on estates. However, evidence from Northern Ireland and the United States suggest they are not popular with taxpayers who link these ideas to subjective anxieties with paying for older care and inheritance tax (Northern Ireland Assembly 2007).
- Rebate schemes tend to focus on helping households on low current incomes but such schemes typically face the high cost of delivering means-tested benefits, even if they are well-targeted.
- There are also income-related ‘circuit-breakers’ which are designed to protect households from paying an excessive share of their income on property taxes or do so on some kind of sliding scale. These are common in North America.
- A common option chosen is to simply delay revaluation – this can be argued to be a de facto form of regressive subsidy to the extent that the property tax is a wealth tax and housing wealth is held more by higher income groups who would benefit from the failure to uplift property values through regular revaluation.
Financing and taxing for local government

Fourth, several countries have nonetheless embarked on property tax reform in recent years. Countries reforming property taxes include: Denmark, Estonia, Hungary, Iceland, Latvia, Lithuania, Macedonia, Netherlands, Russia, Sweden, Greece, Ireland and the UK (the introduction of the council tax in 1993 and, separately, the reform of Northern Ireland’s rates in 2007 and reform in Scotland in 2016/17). The reasons for the reforms have been related to national tax reforms, local government finance reform, specific changes to local taxation based on principles of reducing inequality, raising revenue or tax simplification. Reform is discussed further below.

Fifth, several countries and provinces or states within countries employ variations on land value taxation or site value taxation (Dye and England 2010).

Sixth, a number of countries rely primarily or extensively on local income taxation. We should, however, distinguish between locally-raised income tax and sharing nationally collected revenue, subsequently assigned to local government. Corporate income tax is also often used locally in a way analogous to non-domestic property taxation (and as well as property taxation). Those countries where the largest source of local tax revenue is income tax (i.e. Denmark, Finland, Germany, Norway, Sweden, Switzerland) tend to have local governments who have significant responsibility for redistributive services (i.e. people related services: social services and housing (Slack and Bird 2014). The UK is an exception in that the local delivery of a national welfare service (state school education) is largely funded out of intergovernmental grants.

Finally, local property taxes have wider impacts on economies:

- In the housing market, they may operate to counter-act well known tax biases in favour of home ownership, which may exacerbate market volatility and wider problems resulting from excess favouring of home ownership. Alm et al. (2011) looked at the impact of the US housing market collapse after 2006 and argued that rather than falling house prices damaging the property tax yield, price falls only fed into valuations with a lag and that many local governments were able to compensate through adjusting tax rates.
- Property taxes influence economic decisions more generally as part of the total tax system. Widening the tax base to include more immovable property and land may reduce revenue risk, lower reliance on more mobile (within and between nations), elastic and volatile sources of taxation such as incomes. It may also, on a revenue neutral basis, allow for lowering marginal tax rates on income by shifting tax towards property.
- Recurrent property taxes are often argued to be preferred to taxes on property transactions that may be inefficient because they restrict mobility and that have much more volatile and unpredictable yields (Mirrlees et al. 2011).
- Many countries operate incentives through the local property tax system to encourage investment into specific places, though it is contentious as to what this does for economic efficiency, more generally (Norregaard 2013).
- Local government has an important impact on the overall burden of taxes and this would still be the case if they were 100% funded by central government grants, even if the visibility and saliency were completely altered.

Combining local taxes

The Burt Review (2006) found that in 23 out of 28 countries studied, multiple local taxes were in operation – usually a combination of property and income taxes. However, Burt (2006) argues that public opinion does not support the introduction of new supplementary taxes because it is perceived to be a way of creating more tax revenues rather than redistributing existing levels of
Kenneth Gibb and Linda Christie

revenue (presumption and saliency resurface again). Any effort to introduce such taxes to either supplement a reformed or a new property tax undoubtedly needs to address this particular issue.

There are as many different sets of hybrid systems as countries that run them. Slack (2013) reports seven completely different fiscal arrangements in seven global cities. The income tax element may be a supplement or the core form of local tax; it may be a national surcharge on the national income tax that is then redistributed locally or in some cases it may be a genuinely local contribution. Again, as with property taxes, the rate and the total bill may be capped in different ways by the national government. Slack (2013) found that all cities studied bar London had access to at least five local sources of revenue. London (and UK local government) relies wholly on the council tax for locally-determined revenues (UK business property taxes are levied at a national uniform tax rate and from a local government point of view operate more as a per capita grant than a tax although some changes to this arrangement are currently being considered).

Why combine taxes on a revenue-neutral basis? First, logically, the two taxes would individually have less marginal impact on households introducing a degree of progressivity and limiting the burden of the property tax. This would also alter the distributional outcome of the local tax burden. Second, this would be a simpler alternative to applying one of the various ameliorations to the property tax discussed earlier and may actually allow the authorities to develop a purer property tax albeit with a more modest yield (pragmatically, this may help overcome the residual resistance to property taxes). Third, Hollis et al. (1992) develop a coherent argument in favour of linking local tax type to service provision - services more related to redistributive/need functions could be funded by a combination of national grants and (progressive) local income tax while more local amenity or facility related services would be funded by property taxes. A similar division might logically be applied to non-domestic or business property taxes.

Reforming property tax systems

This penultimate section is in two parts. First, we consider some general principles that promote and constrain the capacity to deliver property tax reform for local government finance. Second, we briefly look at a case study of these questions – the recent experience (2014–2016) in Scotland where the devolved Scottish Government assembled a cross party expert Commission on Local Tax Reform. Once it reported towards the end of 2015, they then encouraged all political parties to bring forward reform proposals at the 2016 Scottish elections.

We have identified the importance of evident challenges and idiosyncrasies found in national local tax systems. We have argued that they also impact on general tax reform questions, and the scope for tax reform, specifically, property tax reform. There continues, as we have seen, to be considerable interest in property tax reform internationally. Many countries and systems of local government wrestle with the potential of property taxes versus the limited political room for manoeuvre they feel they can operate within.

Slack and Bird (2014) distinguish four general issues for property tax reform: establishing the preferred tax base, how to assess the tax base, how to set the tax rate and thus the tax bill, and, how to run the system itself? Almy (2013: 61) concludes: ‘unless the tax structure is simple enough to be efficiently administered, and fair enough to gain the confidence of the population, administrative reform by itself will not succeed’.

Table 31.2 below from Slack and Bird (2014) is a helpful analysis of the challenges and possible ways forward with reform. They focus on six themes, several of which have already emerged in this chapter (i.e. saliency, the presumptive nature of the tax, volatility of tax bills and liquidity constraints). Promising approaches have recurring elements such as regular (annual) revaluations of property in the tax base, phasing in change and investing in voter taxation education.
Many of the problematic dimensions of reform relate to efforts to ameliorate property tax incidence (as we also discussed earlier). Overall, reform is multi-dimensional, political and complex:

property tax reforms could clearly be designed and implemented much more sensibly than appears to have been the case. To do so, however, countries need to recognise clearly both the nature of the task facing would-be reformers and also the complexity of the task they face . . . inextricably related to very long-lived assets and often deep-rooted social beliefs and norms.

(Slack and Bird 2014: 26)

**Case study: reforming the council tax in Scotland**

Our case study of a local tax reform programme, in Scotland in 2015–2016, unearthed many of the technical issues we have examined in this chapter but also clearly demonstrates the importance of politically credible solutions for critical stakeholders and the inertia created by long standing path dependencies.

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**Table 31.2 Strategies for property tax reform**

<table>
<thead>
<tr>
<th>Issues and problems</th>
<th>Promising approaches</th>
<th>Problematic approaches</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Salience</strong>: property tax is more visible than other taxes</td>
<td>Link tax reforms with improvement in local services Phase-in Withhold tax at source and other payment options</td>
<td>Assessment limits PT capping</td>
</tr>
<tr>
<td><strong>Liquidity constraints</strong>: imperfect association between taxpayers’ incomes and PT especially for seniors</td>
<td>Tax deferrals for seniors More payment options Phase-in</td>
<td>Assessment limits PT capping</td>
</tr>
<tr>
<td><strong>Perceived regressivity</strong>: taxes higher as a % of income for low income taxpayers</td>
<td>Tax credits deferrals bundle with other tax reforms Bundle with spending changes low-income housing exemptions</td>
<td>Banding Classified tax rates Progressive tax rates Assessment limits PT capping</td>
</tr>
<tr>
<td><strong>Volatility</strong>: potentially large swings in taxes for some taxpayers</td>
<td>Annual reassessment Index base Taxpayer education Communication in understandable forms Phase-in</td>
<td>Assessment limits PT capping</td>
</tr>
<tr>
<td><strong>Presumptive Tax</strong>: taxbase is inherently arbitrary</td>
<td>Taxpayer education Consultation Accessible appeals process Phase-in</td>
<td>Self-assessment Classified PT rates Assessment limit PT capping</td>
</tr>
<tr>
<td><strong>Inelasticity</strong> is problem for LG, not for taxpayers: taxes do not increase with econ growth</td>
<td>Annual reassessment Index base phase-in</td>
<td></td>
</tr>
</tbody>
</table>

Source: Based on Slack and Bird (2014: table 1, p. 22)
The long shadow cast by the poll tax

The community charge (or ‘poll tax’) was launched in Scotland in 1989 as the headline element of the new ‘paying for local government’ finance system (Department of the Environment 1986). Arguably the contemporary reform debate in Scotland is the direct result and continuing aftermath of this infamous ‘mother of all political blunders’ (King and Crewe 2013).

The funding system for local government was revolutionised in 1989 when the domestic rate system was replaced because of long standing complaints that had been heard sympathetically by then Prime Minister Thatcher. First, the government introduced a much-simplified grant system primarily determined by demography and by local needs alongside greater freedom to impose service fees and charges. Second, the non-domestic rate was nationalised and turned into a grant. After a Scottish-wide revaluation of eligible business properties, a national tax rate was set and revenues collected centrally before being returned to local government on a common per capita basis. Not only did local government lose rate-setting power but they also no longer received the income in proportion to their business property tax base. Third, the controversy surrounding non-domestic rates was nothing compared to that with the community charge – a flat rate tax charged on all adults which was effectively the residual element of the system and bore all of the (now much larger) gearing consequences of only leaving a small share of tax raising powers locally. A further critical reform was to end the principle of 100% rebates for those on means-tested general income based social security. Instead, everyone had to make a minimum 20% contribution.

The new tax’s introduction led to rioting, mass non-payment, local government bankruptcy threats, the downfall of the British prime minister, Mrs Thatcher, in November 1990 and the unseemly race for a politically feasible solution by her successor John Major and the minister responsible, Michael Heseltine. As a result, in 1993, the council tax was introduced. This was to be a form of hybrid property tax based on 1991 capital values but adopting eight bandings wherein each band paid a bill which was a fixed proportion of band D (the reference point set by local government); the Scottish distribution of bands is shown in Table 31.3. The bands’ implicit tax rate (the percentage relative to those in the reference band D) were also much ‘flatter’ than the distribution would have been if taxes were fully proportionate to property values. So high value properties assessed at a minimum of eight times the lowest tax band, only paid a tax of approximately three times that paid the lowest council tax band. Council tax was supposed to be regularly revalued but apart from Wales with a revaluation in 2007, this has not

<table>
<thead>
<tr>
<th>Band</th>
<th>Percentage of all dwellings (2013)</th>
<th>Value range (1991)</th>
<th>Percentage of band D</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>21</td>
<td>Up to £27,000</td>
<td>67</td>
</tr>
<tr>
<td>B</td>
<td>24</td>
<td>£27,001–35,000</td>
<td>78</td>
</tr>
<tr>
<td>C</td>
<td>16</td>
<td>£35,001–45,000</td>
<td>89</td>
</tr>
<tr>
<td>D</td>
<td>13</td>
<td>£45,001–58,000</td>
<td>100</td>
</tr>
<tr>
<td>E</td>
<td>13</td>
<td>£58,001–80,000</td>
<td>122</td>
</tr>
<tr>
<td>F</td>
<td>7</td>
<td>£80,001–106,000</td>
<td>144</td>
</tr>
<tr>
<td>G</td>
<td>5</td>
<td>£106,001–212,000</td>
<td>167</td>
</tr>
<tr>
<td>H</td>
<td>1</td>
<td>£212,001 or more</td>
<td>200</td>
</tr>
</tbody>
</table>

Source: CIPFA presentation made to the Scottish Commission on Local Tax Reform
happened and outside of Wales, 1991 values remain the basis for the tax. The government reintroduced 100% rebates for those on lowest incomes.

Chartered Institute of Public Finance and Accounting (CIPFA) data presented to the Scottish Commission on Local Tax (CLTR) reform provides a snapshot of local government finance in Scotland. In 2013/14, the Scottish local government system spent just over £12.5 billion with the largest components being education (£4.6 billion), social work (£3 billion) and interest payments/other spend (£2 billion). Spending reflects the functional competencies of local government and we should also note that these have significantly changed in recent years with the establishment of national police and fire/emergency services funded directly from Holyrood. On the revenue side, the required £12.5 billion is funded in the following main component parts:

- £7.225 billion from central transfers or grant in aid;
- £2.436 billion in national non domestic rates;
- £1.977 billion from council tax; and
- £877 million from other incomes (fees and charges) and contribution from reserves.

The average band D council tax for 2013/14 was £1,149 and levels varied from £1,024 in the Western Isles (Eilean Siar) to £1,230 in Aberdeen City, though the distribution of payments is quite compressed across the 32 authorities.

Reforming council tax

What are the principal problems associated with the council tax? First, the council tax has not had a general revaluation since it was set up 1991 – not only do new properties and sales have to be recalibrated to 1991 values and bands, but the assumption is that various segments of housing markets, neighbourhoods and towns remain in the same market hierarchy that was identified in 1991. This is quite implausible, not least because of the extensive tenure and economic change under was in the last 25 years, let along local housing market change. This also means that the council tax base is inelastic technically – it does not increase in size unless either more properties are added to the valuation list or there is some form of revaluation or indexation of the tax base. Instead and in the absence of a revaluation, the tax rate would have to increase. Analysis for the Commission (Commission on Local Tax Reform 2015) carried out by Chris Leishman at Heriot-Watt University suggested that nearly three in five (i.e. 57%) properties today are now in the ‘wrong’ council tax band (equally split between being too high and too low).

Second, evidence from the English regions suggests that low value housing market regions pay higher shares of capital value in council tax than do high value market regions (Leishman et al. 2014). In addition to this spatial inconsistency that seems intuitively unreasonable, it also appears that council tax is regressive in terms of payments per decile of the income distribution (Burt 2006; Commission on Local Tax Reform 2015). As a proportion of property value, lower valued properties pay a larger proportion of their value in council tax than do higher valued properties. To the extent that the distribution of property values proxy for wealth held by households, this is not progressive. This is a direct consequence of the banding weighting system. In addition, a system of personal discounts (single adult households) and exemptions further attenuate the property tax.

Meanwhile, and for what turned out to be nine years, and as part of a broader deal (or ‘concordat’) between the Scottish government and its local authority counterparts, there was a council tax freeze paid for out of additional compensation in the Block Grant although local...
governments were ‘fined’ by grant reduction if they choose not to continue with the freeze. The Scottish Government promoted the freeze as a way of protecting household disposable income in difficult times, but it should be recognised that the freeze conferred the greatest absolute benefit to those in the higher council tax bands. Overall, the freeze represented a considerable cumulative process of fiscal centralisation. The council tax freeze cost the Scottish budget £70 million in its first year and a further £70 million in each subsequent year on top of previous years’ resources required to keep Band D payments constant. This implies that, in order to remain at 2008/09 levels in 2016/17, now required an annual subvention of £630 million (nine times £70 million), which amounts to more than £3 billion cumulatively in cash terms over the nine years – a substantial opportunity cost. Post-election survey analysis in 2011, however, suggested that the freeze was the single most popular policy proposal in the election campaign (Mitchell 2015). Good politics, bad policy?

At the same time, and under the UK coalition government’s localism reforms, Whitehall decided to reduce the council tax rebate system (known as council tax benefit) by 10% across the board as part of deficit reduction measures. In England, this involved passing the remaining council tax benefit back to individual local authorities for them to set and manage as they locally thought best (creating in turn a patchwork of local benefit systems). This was not followed in Scotland – instead the 10% shortfall was funded fully by Holyrood and town hall to maintain the level of benefits for low income rebates but a national scheme, now called the Council Tax Reduction Scheme was then introduced, though ostensibly it was much the same as the former national council tax benefit, as least as far as the recipient is concerned.

Finally, the decision was taken to launch a broad based and multiparty commission on local tax reform at the end of 2014. This was carried out through 2015 and reported in November of that year. The intention was that the Commission would provide analysis and options for reform for the political parties to include in their electoral platform for the 2016 Scottish general election.

Reform and the 2015 Commission

The Commission on Local Taxation Reform (CLTR) had as its remit the tasks to look at the reform or abolition of council tax and to address (if it chose to) the council tax freeze. The Commission’s brief did not extend to non-domestic taxation, nor did it include the balance between grant in aid and local revenues, or the system of grant allocation and the broader debate between local government autonomy and central government influence and control.

The CLTR was timed to take evidence and report in time for the development of party manifestos for the Spring 2016 Scottish election. It was a broad-based commission featuring all of the major political parties (except the Scottish Conservatives through their choice), independents, relevant professional bodies and it was co-chaired by the local government minister and the convener of the Convention of Scottish Local Authorities (COSLA). The Commission was serviced by a Secretariat drawn from seconded Government and COSLA officials.

Commission recommendations and party responses

The Commission duly reported and was strong on diagnosis of what was wrong with the present system. The Commission recommended that the council tax should be replaced and the freeze ended. As to how it should be replaced, local tax reform ideas remained at a high level of abstraction favouring a (regularly revalued) property tax solution but one that could be
augmented by an element of income taxation. The Commission suggested that further work would be required to assess the practical basis for a land value tax as an alternative to a more conventional property tax. The Commission also made it clear that they expected the main political parties to respond in their (Spring 2016) Scottish election manifestos in how they would secure local tax reform and build on the Commission’s recommendations.

From February 2016 onwards, political party proposals started to emerge:

- The governing Scottish National Party (SNP) proposed a modest set of reforms entailing a reweighting of the bands so that higher value properties pay more, an additional high value band, an end to the freeze, additional support for low income households in higher value bands, hypothecation of extra revenue from higher bands into education and consultation over localising a proportion of future Scottish income tax receipts. There would be no general revaluation.
- The Conservatives low tax commission proposed broadly similar though less progressive reweighting of bands to the SNP proposal (i.e. a relatively minor reconfiguring of the existing council tax system but also without a general revaluation).
- Scottish Labour recommended a new property tax, one which included a fixed element but with higher percentage tax rates on properties above a certain level. This would operate locally in terms of rate-setting and would retain a national system of rebates. The precise local nature of the tax was, however, under-specified.
- The Liberal Democrats moved from their longstanding support for a local income tax towards a land value tax.
- The Scottish Greens had the most thorough-going reform proposals involving a five-year transition to a property tax with a long term plan to use this as the basis for a future land value tax. The proposal also included a £10,000 allowance, a revaluation (which would distinguish land from buildings) and higher tax yields from more expensive properties.

The SNP were re-elected but only as a minority government. Their proposals concerning increased tax rates for higher value properties and no general revaluation were duly enacted, as was an adjustment to the social security element to protect below median income households from uplift in tax bills created by the higher bands, though they were not able to command a majority in terms of hypothecating extra income to education and as yet have not moved forward with the idea of localising income tax receipts. The freeze was ended but increased tax bills were capped at 3%.

The question of more thorough-going comprehensive reform is, for the time being, on hold. An interesting question is why did the outcome not go further? While it may be considered that there has been progress of a sort – in reducing the flattening effects of the bands and putting an end to the freeze, there is clearly no appetite from within Government for wider reform and reintroducing regular revaluation, although the devolved government in Wales has successfully revalued domestic properties. Some of the proponents of more systemic reform of local government finance are more positive and see the recent experience as progressive and moving Scotland, albeit slowly, in the right direction. In a longer term context, it may turn out to be most instructive that the SNP and the Lib Dems have now both turned away from a local income tax as their preferred solution towards property taxation, and in an even longer time period, it does seem that land value taxation in principle is moving towards wider acceptability and is certainly no longer viewed in Scotland as fringe thinking.
Final reflections

The finance system that governs local taxes and spending is the result of incremental changes over time to elements of grant systems, tax policy and the distribution of services and functions across local and central government. It is also inherently determined by the fundamental degree of autonomy and discretion allowed to municipal government by higher tiers. These factors and also the fundamental geography and scale of local government units are necessary components shaping the form and level of local taxation, and, to an extent, its effectiveness and acceptability to citizens. And that is before we actually look at the design and structure of the local tax system.

There is a dissonance between economic and in-principle arguments about local taxes, and how they are perceived by people and politicians. Academic commentators are widely positively disposed to property taxation as an instrument for doing good but that there is also recognition that as a salient, highly visible, presumptive tax, arguments over incidence can be trumped by the question of ability to pay from current income. Ironically, this has led to many of the difficulties we see with property taxes around the world, as governments attempt to assuage voters by softening the incidence of the property tax through reforms like circuit-breakers, postponing revaluation and by employing other ostensibly progressive measures to alleviate the symptoms. Finding the right way to compensate low income tax payers remains a critical issue. Land and property taxes may have desirable impacts on housing markets, resource allocation and land use but that also depends on their design. There is, undoubtedly, plenty of international evidence suggesting that, all too readily, the best laid reform plans can all go wrong.

Systems of local tax and the inter-governmental finance and distribution of services are highly idiosyncratic. They are the product of long periods of evolution and punctuated periods of reform (and hence exhibit considerable path dependency). With such different contexts, design details and complex interactions with other taxes, one must be cautious about reading too much into the simple transferability of local tax systems across nations with often very different governance institutions. Policy transfer in order to reform local tax problems should not be embarked on lightly.

The recent Scottish experience of attempted tax reform is instructive since it featured many of the issues thought to inhibit purposive property tax reform (Table 31.2 above), for example, as a result of the salience and presumptive nature of council tax, there was clearly an unwillingness to contemplate general periodic regular revaluation, and because of liquidity problems, relatively complex means-testing was introduced to ameliorate the impact of higher band weightings on more expensive property for cash-poor households. Path dependency played two roles, arguably, in terms of the difficulty of moving away from 1991 values or the freeze in tax bills (though this was phased out via an initial cap of 3% maximum increases).

Finally, from a British perspective, it is apparent that cities and national systems of local government elsewhere typically have more than one local tax at their disposal and frequently have many taxes at their disposal. More taxes of lower yield but revenue neutral overall may also of course reduce revenue risk as well. In an international context, nonetheless, it remains odd to restrict oneself to one form of domestic local tax.

Notes

1 The cumulative burden of annual property taxes is capitalised into the present value (i.e. the asset value of a property), in this case reducing the property’s value in terms of what the bidders in the market are willing to pay compared to a situation without such a tax.
Financing and taxing for local government

2 And now also used for the new property tax in Ireland.

3 It is commonly argued that revaluation need not adversely affect tax bills for those living in higher value property – if the overall tax bill (value times tax rate) does not change. However, not revaluing is in the interests of those owners of appreciating property values.

4 And common media or commentator criticism about profligate high tax rates set by local government of course ignores the structural causes of high tax rates i.e. the failure to revalue.

5 Nor did they proceed with adding extra high value bands.

References


