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An assessment of the feasibility of a local income tax to replace council tax in Wales

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Views expressed in this report are those of the researcher and not necessarily those of the Welsh Government

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Glossary

Acronym/Key word	Definition
DWP	Department for Work and Pensions
CTRS	Council Tax Reduction Scheme
HMRC	Her Majesty's Revenue and Customs
OECD	Organisation for Economic Co-operation and Development
PAYE	Pay-As-You-Earn
SFS	Standard Financial Statement
UC	Universal Credit

1. Introduction

- 1.1 Local government plays a vitally important role in the lives of every citizen in Wales, providing the services which educate our children, care for our elderly, dispose of our waste and light our streets. Local authorities would be unable to provide these services without the multi-billion pound funding framework that underpins them. Local authorities in Wales spend around £9 billion a year on the revenue costs of delivering services and around £1 billion on capital investment. The funding system comprises £3.2 billion in government support (Revenue Support Grant), £2.7 billion from locally raised property taxes (council tax and non-domestic rates), mechanisms for capital financing and an extensive governance and audit framework to ensure the proper use of public money.
- 1.2 To maintain these systems, the Welsh Government delivers numerous pieces of legislation each year and develops the policy that shapes these – but new demands and opportunities mean policy and legislative processes are ever-changing. Within the Government’s five year strategic plan, Taking Wales Forward 2016-2021¹, there are a number of specific commitments that relate to local government finance, including to:
- work with local government to review council tax to make it fairer;
 - deliver a tax cut (non-domestic rates) for 70,000 businesses; and
 - reform local government funding to help councils become more sustainable and self-sufficient.
- 1.3 In response to these commitments, the Welsh Government is developing a system of local taxation², which seeks to address fairness for citizens and businesses while sustaining funding for local services. Evolving council tax and non-domestic rates policy is an integral part of a phased reform of the wider funding framework for local government in Wales.
- 1.4 As part of this work, an expert-led Local Government Finance Reform Working Group was established in 2016 to consider options for longer-term reform of local taxes. Established to test the possibilities in an applied and practical way, the

¹ [Taking Wales Forward \(2016\)](#)

² [Reforming Local Government Finance in Wales: An Update](#) (November 2019)

group has considered four 'themes for assessment' of the alternative approaches for local taxes:

- **People and taxpayers** – Such as local accountability and public acceptability of change;
- **Sustainability of local services** – Such as the amount of revenue raised for local services; degree of buoyancy and tax incidence;
- **Fairness** – Including progressiveness; the likely winners and losers of change; appropriate reliefs and exemptions; and possible requirements for redistribution; and
- **Practical Implementation** – Such as how the entity being taxed would be registered and valued; upfront costs in developing infrastructure and capability; efficiency of collection and administration; affordability; possible behavioural impacts; and the legislative requirements, including constitutional or devolution constraints.

1.5 As part of its work, and in reflecting on these themes, the working group considered the possibility of longer-term reform of council tax by charging on the basis of income and ability to pay rather than property value.

1.6 The main purpose of this research was to explore the feasibility of a locally-administered tax based on assessments of people's income in Wales, to replace the existing council tax, and to identify any further work which may be required to deliver such a concept.

1.7 The main aims of the research were:

- To appraise the options for shifting the design of local taxation in Wales from being based on property values, to being based on assessments of income as an indicator of ability to pay;
- To translate the conceptual options for a local income tax into practical action, to include: identifying the preparatory work required for each option, details of any associated costs and barriers to implementation;
- To consider broadly the impact of a local income tax in Wales on taxpayers, taking account of potential changes in overall tax burdens for households in relation to other taxes they pay.

- 1.8 For ease, we use the shorthand of “local income tax” throughout this report, however, it is important to note that the concept discussed here is whether local tax bills could be based on income assessments or means tests, and still administered and collected by local authorities. This concept differs greatly from the traditional ideas of local income taxes.
- 1.9 The design of a new local tax will inevitably be linked to an assessment of how well it overcomes some of the issues of the system it replaces, in this case council tax. Annex 1 contains an overview of the workings of the current council tax system and an assessment of the connection between council tax and ability to pay.
- 1.10 This report will set out the research methodology, before discussing the findings in relation to international uses of local income tax, and key factors in the design, implementation and impact of a local income tax.
- 1.11 This research was conducted during the Covid-19 pandemic, which brought with it an increased emphasis on both funding for public services and household affordability. It is not felt that this context skewed the findings of the research, but it did introduce an additional factor in the interview discussions which we welcomed as participants were able to reflect on current circumstances.

2. Methodology

2.1 The methodology for this research comprised a review of existing literature on local income tax as well as primary qualitative research interviews with industry experts and stakeholders.

Literature review

2.2 In order to understand the use of local income tax in other countries, a rapid evidence assessment of relevant literature was conducted (HM Treasury, 2020, p. 52). This was the most appropriate form of review in the timescale and because of the initial scoping nature of the research.

2.3 To identify relevant literature, major databases were searched using keywords such as “local income tax”, “municipal income tax”, “state income tax” along with terms such as evaluation, review, analysis, evidence, research or impact. These wide search terms were needed because local income tax is labelled differently across the countries which use it, mainly because they have different ways of naming their sub-national governments. Filters were used to narrow results to publications written in English and those less than ten years old. Full details of all data sources, key words and search filters are provided in Annex 2.

2.4 Welsh Government Information, Library and Archive Services identified 65 initial publications of relevance. An additional 17 publications were identified by a Knowledge and Analytical Services researcher from key references in the initial literature and the researcher’s previous experience of research projects on local taxation. A total of 82 publications therefore fell into the scope of the literature review. These included academic, governmental and third sector documents. Local income tax was sometimes discussed specifically in the literature, or as part of wider considerations of fiscal decentralisation and sub-national sources of revenue. A diverse range of literature such as this means different research standards will have been applied, making it difficult to be systematic in assessing quality, but because of the practical nature of the research and its thematic approach, the breadth of literature to be considered was prioritised. Where findings from the literature have specific limitations, this has been reflected on in the analysis. A further reason for taking this approach was that the literature considered covered a wide range of geographical jurisdictions, because of a lack of previous research on this form of tax in Wales. For this reason, none of the

findings from the literature would be directly applicable to the Welsh context, but raised general themes and issues which could be universally applicable. This justified casting a wider net in the literature scope to make sure all factors were identified and could be discussed during interviews.

Interviews

- 2.5 The initial literature review was supplemented by a number of semi-structured interviews with key stakeholders, to gather expertise and views on the key factors identified from the literature. The sampling frame consisted of professionals with expertise or experience in local taxation and household finance, and knowledge of the Welsh context. Participants were suggested by Welsh Government officials, or identified from the literature. The way in which the sampling frame was designed introduced some risk of excluding potential participants with expertise if they were not known to the researchers and government officials the researcher consulted with, but it was felt that the frame identified would allow a sufficiently thorough exploration of the issues within the scope of the project and its timescales. As the research was qualitative, the aim was not to be representative of the population, but to identify issues and barriers in the topic area.
- 2.6 Interviewees were from a mixture of professions, including government policy officials, academics and independent researchers. All participants were UK-based, and had previous experience of local government finance in England, Wales, or other devolved nations of the UK.
- 2.7 20 individuals were approached to take part in interviews, with 18 ultimately participating. The two participants who did not participate did not respond to the invitation. All interview participants were asked to suggest other individuals who could contribute to the research as a measure to reduce the risk of missing some potential participants.
- 2.8 As the research took place during the Covid-19 pandemic, it was not possible to conduct interviews in person. Government Social Research guidance was to suspend all face-to-face data collection during the pandemic. Alternative options such as survey research were considered, but it was felt that interviews could provide more scope for open-ended responses and discussion of the complex issues thrown up by tax reform, and video-conferencing would allow the interviewer to ask supplementary questions which would not be possible through

surveys. Interviews were conducted and recorded using the video-conferencing software Microsoft Teams. Two interviewers were used, one to lead discussion and another to take key notes.

- 2.9 Invitations were sent to participants by email on 1 July, with interviews taking place between 10 July and 12 August 2020. The summer period may have been a factor in the lack of response from two invited participants because of periods of annual leave, but this was unavoidable, and had a minimal impact on the overall response rate. The interviews were a mix of single individuals, pairs and larger focus groups of up to 6. Where focus groups were used, this was for reasons of time efficiency, but this mixed format worked well. In sessions of multiple participants more discussion was generated where different views were expressed, whereas in smaller sessions, participants could reflect at length on their ideas and experience.
- 2.10 The style of the interviews was semi-structured; because of the complex and interrelated nature of the topic being discussed, the interview framework was used as a prompt and a reminder of key issues, rather than as a rigid list of questions. The interview framework followed the structure of the coding framework used in the literature review, to allow evidence on similar topics to be easily synthesised during analysis. This also gave a logical structure to the interview, starting with high level design factors and leading on to more specific practical issues of implementation and impact. It was also tailored to each interview participant in advance based on their previous experience to make the best use of time, as some participants had expertise in particular areas of taxation, but not necessarily all of the factors which might go into tax design. The interview framework was not piloted, but did evolve incrementally over the course of the interviews in terms of structure and order of questions (annex 3).
- 2.11 With the consent of all participants, interviews were recorded in Microsoft Teams. These recordings were not transcribed in full, but a Knowledge and Analytical Services researcher listened to them during analysis to draw out key quotes. Notes were also taken during the interviews, but given the complex nature of the discussions it was felt necessary to have recordings to support the best quality analysis of the interview data. The use of video-conferencing software for interviewing and recording did not present any issues of data quality.

Ethical considerations

- 2.12 At the planning stage of the research thorough consideration was given to any ethical issues presented by the topic or the methodology.
- 2.13 The main issue identified, which would apply to all primary research conducted during the same time period, was sensitivity to the potential for target participants to have heightened workloads and/or difficult personal circumstances as a result of the Covid-19 pandemic, which could make it difficult for them to be involved. This was factored into the decision to use video-conferencing for interviews, as it was felt to offer the greatest flexibility and could be completed in under ninety minutes.
- 2.14 Consideration was also given to the risk of excluding participants who did not have access to or proficiency in video conferencing software. To mitigate this risk, all participants were offered an alternative option of telephone interviews, but none took up this offer.

Approach to analysis

- 2.15 Given that the purpose of the research was to understand the feasibility of local income tax, the nature of the literature review was thematic, seeking to identify and better understand the key issues associated with local income taxes. This was favoured over other qualitative approaches, such as discourse or narrative analysis, because of the practical focus of the research, and because the evidence assessed related to academic and professional experience of local government finance and economics, rather than personal views or reflections.
- 2.16 Key notes were recorded from the publications and coded using qualitative data analysis software NVivo. Any tax reform is multifaceted, throwing up lots of issues and considerations. Thematic analysis using NVivo helped to organise the issues and make the findings most useful as evidence of the feasibility of a local income tax. Analysis started with open coding, where the notes from the literature were first organised into 38 topics, with all references to these topics in the literature coded and collated for further analysis. Axial coding, where codes are grouped together, was then used to connect these 38 codes with three different stages of tax reform which the research sought to understand; design, implementation and impact. This helped to organise and present the themes chronologically, and is useful to be able to map out what the process of reform may look like, and when key issues may arise. These themes were then used to inform the development of

the interview framework, so that evidence from the literature and interviews could be synthesised and presented coherently.

- 2.17 Both the literature review and the interview research were qualitative in nature, as the goal was to identify the nature of the issues which a local income tax would present if implemented in Wales. The issues considered ranged from technical economic aspects to the everyday realities of taxation for the taxpayer. Once key quotes had been recorded from the interview recordings, these were coded using the thematic framework developed during the literature review. Analysis was conducted iteratively, moving back and forth from the literature to interview evidence to develop a full picture of each theme. Where views expressed in interviews concurred or contrasted with evidence from the literature, this was drawn out to demonstrate areas of consensus and identify gaps in the evidence base which may warrant further research.
- 2.18 The methodology used produced a wide range of qualitative data of relevance to the feasibility of local income tax in Wales. The necessity to use video-conferencing as opposed to in-person interviewing did not compromise the quality of interview data and was, on balance, the most appropriate way to conduct the research in the wider circumstances.
- 2.19 Future research is likely to require a more quantitative approach to model the fiscal realities of this alternative form of local taxation. The quantitative work could be informed by the issues discussed in this research.

3. International uses of local income tax

- 3.1 When considering a fundamental change to the design of local government finance, a useful starting point is to assess how local governments are funded in other countries. The example of another country can highlight potential benefits as well as issues inherent in different forms of taxation.
- 3.2 Systems of local finance across the world are highly varied. Despite the range of different approaches which can be identified, it is arguable that some convergence can be seen over time, with more instances of borrowing and learning from other policy and organisational models (Loughlin and Martin, 2004b, p. 4).
- 3.3 As part of the assessment of the feasibility of local income tax, a literature review was conducted to find examples of its use in other countries. From the outset of the research it was accepted that it was unlikely that any other international system could be directly applied to Wales; as a devolved nation of the United Kingdom, Wales has unique cultural and economic characteristics set within a specific legal framework. As noted by Lotz (2012, p.2), 'some differences in systems depend on differences in the basic characteristics of societies'. In conducting comparative research it is important to remember that tax systems are not developed in a vacuum; they are the product of a whole range of variables. The current system is always linked to its predecessors, with some systems being reformed at pace whereas others may have evolved incrementally over a long time (Welsh Government, 2016, p. 52). Design principles are influenced by the varied objectives of countries in relation to public service provision, preferences for centralisation versus localism, and different interpretations of their own economic evidence bases (Lotz (2012, p.2). As the system in Wales can never be divorced from its social and historical underpinnings, the same applies to all other jurisdictions, which are just as much products of their own economic history. With the importance of context in mind, comparative research nonetheless provides a rich source of knowledge to better understand how local income tax works in those countries that utilise it.
- 3.4 Conducting a comparative analysis of local taxation throws up challenges of labelling; different terminology is used to describe the same or similar things, making it difficult to compare like with like. Many countries have multiple levels of sub-national government, which discharge varying functions, some or all of which

charge additional income taxes to the national income tax. Information on the individual workings of each jurisdiction's tax system is not always readily available.

- 3.5 Informed by these potential issues, the database of the Organisation for Economic Co-operation and Development (OECD) was chosen as the best evidence base to narrow down which of its thirty-six member countries currently use a local income tax. The OECD have measured the tax autonomy of state, regional and local governments of member countries since 1953 (Dougherty, 2019, p. 4). The data used was from their most recent assessment in 2017. Although there may have been changes in the systems of local taxation in the three years since this revenue data was reported, it was assessed to be the most up to date source for a wide range of countries, and the data source which best overcame the issues of labelling.
- 3.6 Different governments will expect citizens to make financial contributions to public services in a range of different ways, but not all of these contributions will be defined as a tax. The OECD defines a tax as a 'compulsory unrequited payment to general government'. It is unrequited in the sense that the services or benefits which the tax funds do not necessarily relate directly or proportionately to the amount of tax paid. As with the current council tax system, an individual in a top band property does not necessarily receive more or better services than a comparator in a lower band property, but all contributions are used to fund local services.
- 3.7 The OECD subdivides their revenue data into three sub-sectors of government; central government³, state/provincial/regional government⁴ and local government⁵.

³ The central government sub-sector includes all governmental departments, offices, establishments and other bodies which are agencies or instruments of the central authority whose competence extends over the whole territory, with the exception of the administration of social security funds. Central government therefore has the authority to impose taxes on all resident and non-resident units engaged in economic activities within the country.

⁴ This sub-sector consists of intermediate units of government exercising a competence at a level below that of central government. It includes all such units operating independently of central government in a part of a country's territory encompassing a number of smaller localities, with the exception of the administration of social security funds. In unitary countries, regional governments may be considered to have a separate existence where they have substantial autonomy to raise a significant proportion of their revenues from sources within their control and their officers are independent of external administrative control in the actual operation of the unit's activities.

⁵ This sub-sector includes all other units of government exercising an independent competence in part of the territory of a country, with the exception of the administration of social security funds. It encompasses various urban and/or rural jurisdictions (e.g., local authorities, municipalities, cities, boroughs, districts).

- 3.8 The significant number of different taxes about which OECD collects data are organised into a typology with a number signifier. The most relevant revenue type was identified as 1000 – Taxes on income, profits and capital gains. Category 1000 does not relate solely to individual income as it includes taxes levied on income and profits of enterprises and corporations. However, a distinction is made in the data between individual income tax (1100) and corporate enterprises (1200).
- 3.9 An initial judgement as to which countries use a local income tax was made by analysing tables 6.13-6.48 of OECD Revenue Statistics, which detail each countries' tax revenues by sub-sectors of government. All those who had recorded receiving income from local government in category 1000 in 2017 were identified as having a local income tax. All those who recorded receiving income from state/regional governments in 2017 were also noted as having a higher-level local income tax. It is not possible to decipher from this data any further information about the practical workings of the local income taxes, so it should be acknowledged that the revenue sources described as local income taxes by OECD represent a range of different administrative systems and encompass varying degrees of fiscal decentralisation.

Table 3.1: 18 OECD Countries by local income tax as a proportion of total local tax revenues and entity type, 2019

The table shows that Sweden has the highest proportion of total local tax revenues from local income tax (97.6 percent), with the USA having the lowest proportion (5.8 percent).

OECD country	Local income tax as a proportion of total local tax revenues (%)	Individual or corporate entities
Sweden	97.6	Individuals Only
Finland	92.1	Individuals and Corporate Entities
Denmark	89.3	Individuals Only
Norway	86.0	Individuals Only
Latvia	84.8	Individuals Only
Switzerland	81.2	Individuals and Corporate Entities
Iceland	80.1	Individuals Only
Germany	79.4	Individuals and Corporate Entities
Slovenia	75.0	Individuals Only
Poland	62.7	Individuals and Corporate Entities
Japan	48.5	Individuals and Corporate Entities
Belgium	35.4	Individuals Only
Italy	29.4	Individuals and Corporate Entities
Turkey	27.2	Individuals and Corporate Entities
Portugal	25.3	Individuals and Corporate Entities
Korea	18.3	Individuals and Corporate Entities
Spain	16.3	Individuals and Corporate Entities
USA	5.8	Individuals and Corporate Entities

Source: Tables 6.10 and 6.12, OECD Revenue Statistics 2019

- 3.10 As can be seen in Table 3.1, eighteen countries were identified as currently using a local income tax. Of these eighteen, eleven countries charge a local income tax to individuals and corporate enterprises, with seven countries applying the tax only to individuals. Five countries (Belgium, Germany, Spain, Switzerland and the US) were identified as having both local income tax and state/regional income tax. All of these countries have federal or regional governmental structures, whereas all of the systems which were identified as having only local income taxes have unitary governmental structures.
- 3.11 Although Table 3.1 demonstrates that local income taxes are very commonly used, it is useful to know the extent to which these countries rely on local income taxes. If local income tax comprises a small proportion of local revenues, this may indicate limitations in it as a form of taxation. The balance of local government funding varies significantly between countries, with some relying on a mix of forms of local taxation. It has been noted previously that countries which formed part of the British Commonwealth tend to be more reliant on property taxation (Kitchen and Slack, 2017, p. 9). For example, in 2017, Australia reported that 100 per cent of its local government revenue was property taxation (OECD, 2019, p. 285). Similarly, New Zealand generated 89.4 per cent of its local government revenue from property taxation, the remainder being sourced from taxes on goods and services (ibid, p. 287).
- 3.12 With this in mind, further analysis was conducted on those countries identified as having a local income tax to assess what proportion of the total local tax they collected was income tax. This would indicate the level of reliance on local income tax in their wider local taxation system. Tables 6.10⁶ and 6.12⁷ of the OECD Revenue Statistics were used to calculate the proportion which income tax comprised of total local tax revenue. As can be seen in Table 3.1, for the eighteen countries which use a local income tax it makes up a small proportion of local tax revenue in some (less than 20 per cent of revenue in the US, Spain and Korea) and the majority of local tax revenue in others (over 90 per cent in Finland and Sweden). Sweden has the highest proportion of local income tax at 97.6 per cent; in fact, the majority of Swedish citizens only pay local income tax, with national

⁶ Main local government taxes as per cent of total tax revenues of local governments (federal/regional countries)

⁷ Main local government tax revenues as per cent of total tax revenues of local governments (unitary countries)

income tax levied only on the highest earners (PWC, 2019; Gibb and Christie, 2015). Although commonly used, the level of reliance on local income tax as a revenue source varies between those countries who currently use it.

- 3.13 As the focus of this research was to understand the practical factors in the design of a local income tax, the OECD data presented in Table 3.1 was supplemented by an extensive academic and governmental literature review which sought to better understand the workings of local income tax in the eighteen countries identified, to the extent that such information was available. The literature reviewed contained very little information regarding local income taxes in Latvia, Poland, Slovenia, Spain and Turkey.
- 3.14 The different variants of local income tax which operate successfully in other countries do so because they are suitable for the practical arrangements and traditions of those countries, meaning they would only be directly replicable where conditions allowed. For example, it was common in the countries considered for all citizens to submit annual tax returns or declarations of income. By contrast, in the UK, the need for tax returns is minimised, meaning that at present only the self-employed, or those who are employed and receive additional forms of income such as rental income, are required to submit a tax return (UK Government, 2020). Based on the literature reviewed, it seems that all taxpayers are required to submit annual tax returns in at least six⁸ of the countries identified as using a local income tax. The need for tax returns is actively minimised in current UK tax policy, whereas they form an established part of economic culture in many other countries. Practical factors of this kind may have significant implications for the feasibility of local income tax in Wales, and will be considered further in section 5.
- 3.15 Within the eighteen countries considered, some set a fixed rate across all local governments, whereas others give local discretion to set their own rates. In Belgium, Denmark, Finland, Iceland, Sweden, Switzerland and the USA, local governments have the power to set the rate of local income tax, meaning there can be variation between the rates charged across the local authority areas. In some countries the rates vary significantly, such as in Belgium where rates vary between 0-10 per cent. By contrast, in Germany the tax rates are uniform across

⁸ Belgium, Denmark, Finland, Iceland, Italy and Switzerland.

the Lander, but this is consistent with a system which is decentralised in terms of tax assignment, rather than tax powers.

- 3.16 The way in which revenues are equalised across local governments provides some useful insight for Wales. For example, in Denmark and Sweden, local income tax is deducted at source and paid by employers to the central government. Rather than transferring the actual amount raised by a local authority to them, the central government transfers the amount of revenue which the local authority budgeted for that year, making up any shortfall. In Denmark, local authorities are permitted to base their annual budgets on their own local expectations of growth in taxable incomes for the following year, whereas in Sweden they must use central government estimates. Either way, because authorities always receive the amount that they budgeted for, they are shielded from unforeseen cyclical swings in income levels which can be associated with income based taxes (Lotz, 2012, p.16). This can be contrasted with the system in Norway, where employers transfer revenues directly to the municipalities who retain a share and transfer the remainder to central government, increasing their exposure to volatility in the tax base (ibid).
- 3.17 The most significant finding from this review of international uses of local income tax is that there is no current example of a local income tax which is both assessed and collected by the local authority directly. In all of the eighteen countries examined, the evidence would suggest that local income tax is collected at source through the equivalent of Pay-As-You-Earn (PAYE) and Her Majesty's Revenue and Customs (HMRC), and then redistributed to local governments. This form of local income tax, often described as a 'piggy-back tax' because of the way it attaches to the existing national income tax administration, has advantages of cost and administrative load, because it is based on existing income assessments. An additional requirement is a need to accurately determine each taxpayer's place of residence to the local authority level (Lotz, 2012, pp. 13-14), which is particularly important where rates of local income tax are variable between areas.
- 3.18 A local income tax for Wales in which local authorities are responsible for the assessment and collection of local income tax, would therefore be a unique version of a local income tax not seen elsewhere. The use of deduction at source through PAYE, so commonly seen internationally, is not currently possible within

the devolution settlement as a replacement for local taxes. This means that there is no direct example of a local income tax system which can be transposed to Wales within the context of council tax and non-domestic rates. Welsh Ministers do, however, have devolved powers to determine how local taxation systems are designed so long as the revenue is used to fund local government expenditure.

Key points:

- Eighteen out of 37 OECD countries use some form of local income tax.
- Evidence suggests that in all of these countries the tax is collected at source through the equivalents of pay-as-you-earn and HMRC.
- Local income tax makes up a small proportion of local revenues (less than 20 per cent in some countries, such as the US, Spain and Korea), whereas it represents over 90 per cent of local revenues in Finland and Sweden.
- At least six of the eighteen countries identified require universal self-assessment tax returns for all taxpayers.
- Local discretion over tax rates is common, but varies in terms of the range of tax rates.
- There are some useful lessons to be learnt about equalisation from Denmark and Sweden.
- There are no current international examples of a local income tax which is assessed and collected at the local level, as is being considered for Wales.

3.19 The remainder of this report will use evidence from the literature and stakeholder interviews to assess the feasibility of a local income tax in Wales, focusing on assessment and collection of the tax at the local level. The findings of the research are organised chronologically into three stages of consideration: factors in the design of a local income tax, steps in the implementation of a local income tax, and measures of the impact of a local income tax.

4. Design of a local income tax

4.1 Many of the factors which determine the design of a replacement system of local taxation are interlinked and interdependent; for example, the type of income which can be included in an assessment of ability to pay is dependent on the system used to calculate liability as well as the level of access to information. Equally, the size of the tax base is dependent on the types of income included in assessments of ability to pay. The following sections attempt to set out, with reference to previous research in this area and evidence from stakeholder interviews, the key factors in the design of a local income tax for Wales. The main focus will be defining ability to pay, and considering how local authorities could use it to administer a local tax.

Designing indicators of ability to pay

4.2 The main goal of a local income tax would be to improve the link between ability to pay and local tax liability, so that every bill is affordable. This could form part of the wider goals of the Welsh Government to make council tax fairer, tackle poverty and create a more equal Wales. It has been argued that fairness requires the tax to be applied to all forms of income (Local Government Finance Review Committee, 2006, p. 93); if it were not, individuals with some taxable forms of income would be disadvantaged in comparison with those who have different categories of income. This would risk perpetuating some of the unfair aspects of the current system. To design a local income tax that is as fair as possible, a comprehensive list of indicators of ability to pay would need to be developed, accounting for various forms of income and wealth. The smaller the scope of income and wealth which is relevant to local income tax, the more difficult it becomes to achieve equality of sacrifice across all taxpayers (McCluskey, WJ, 1998, p.48). These indicators would also need to be accurate and reliable.

4.3 A starting point may be to define the tax base in the same way as HMRC does for national income tax. This was certainly an assumption made by many interviewees, who felt that this would make the most sense for the taxpayer, who would expect their income to be defined in the same way for national and local income tax. However, another interviewee highlighted the opportunity to take a second look at the definition of income for national income tax purposes to ensure

that it still represents the best approach, and that it would be well suited to a local tax:

‘The default thinking is that whatever HMRC collects is what we should call income, but the way that income tax is defined reflects a particular set of assumptions and decisions taken by HMRC over a long period. People think that it’s a definitive definition of income, but it is one of a set of options. What you define as income is a choice.’

- 4.4 If a local income tax were designed to apply to all forms of income, this would maximise the size of the tax base and in turn decrease the marginal tax rate (Local Government Finance Review Committee, 2006, p. 93). On the other hand, increasing the scope of the forms of income which are part of the tax base inevitably increases the level of complexity involved in assessing liability (ibid). As noted by the Commission on Local Tax Reform in Scotland in their assessment of local income tax, it is challenging to achieve a balance between fairness and administrative workability in one single form of taxation (p. 76).
- 4.5 An attempt to define ability to pay highlights the importance of contrasting measures of income with indicators of wealth. Some forms of wealth tell us nothing about the income available to the individual, in the same way that a lack of income does not mean someone has no financial assets. The ONS defines ‘total wealth’ as a combination of net property wealth, net financial wealth, physical wealth and pension wealth (ONS, 2019). Between 2016 and 2018, analysis of the Wealth and Assets Survey indicated that the median total household wealth in Wales was £253,200, lower than the median average for Great Britain of £286,600 (ONS, 2019). Net financial wealth and physical wealth made up the smallest proportion of total wealth in Wales (20 per cent), whereas pension wealth comprised over half (52 per cent) of total wealth, and property wealth made up 28 per cent (ibid). A local income tax, if based purely on income, would exclude property and physical wealth from the tax base, which collectively make up 38 per cent of total wealth in Wales.
- 4.6 In terms of public views on what could form part of the definition of ability to pay, it is useful to reflect on the public consultation conducted by the Scottish Government in 2008. This was part of proposals to implement a flat rate of local income tax on all income other than that from savings and investments (Scottish

Government, 2008, p. 10). Based on a sample of 418 individuals, the consultation found that 79 per cent would support taxation of earned income or wages. 30 per cent supported a tax on income from savings, with a fairly even split in opinion on taxation of pension income. The survey also asked for opinions on taxation of second property income and income from financial investments, with 72 per cent agreeing with the former and 47 per cent agreeing with the latter (ibid, p.21). The age demographic who were most in favour of taxing income from pensions were those aged over 65 (ibid, p. 21-22).

4.7 These survey results suggest that the design of a local income tax for Wales would benefit from some degree of public consultation on what would be the fairest way to assess ability to pay. Whatever is included in a final definition of ability to pay, the risk is that those who stand to be negatively affected are most likely to make their criticisms known.

4.8 In the following section consideration will be given to a range of income and types to assess the benefits of their inclusion as indicators of ability to pay, and any challenges they may present.

Indicators of ability to pay: income from employment

4.9 The major source of income for the majority of taxpayers in Wales is income from employment. In the 2014-15 tax year, Wales raised £33.4 billion through non-savings, non-dividend income, 78 per cent of which was derived from employment income (Ifan and Poole, 2018, p. 19). In terms of the different forms of income which could be used as indicators, income from employment is likely to be the least controversial.

4.10 Local income tax is commonly seen as benefitting from buoyancy in that the level of revenue which can be achieved will rise in line with growing wages. Equally, this can introduce instability into revenue rates as they will reflect any dips in incomes during periods of recession. A localised income tax to replace council tax would not necessarily need to be designed to be at risk of income fluctuations. The budgeted annual expenditure of a local authority could be fixed at the beginning of a financial year and the liability divided amongst the tax base accordingly (this is the existing procedure for the setting of council tax levels). This may be practically complex though, and may require the use of income bands or thresholds.

- 4.11 Looking more closely at employment income, it is known that Wales takes a much higher share of income tax from public sector employment than the rest of the UK (Ifan and Poole, 2018, p. 20). The most common private sector employers in Wales are industries such as manufacturing, wholesale and retail trade and construction (ibid). Recent OECD data (2020b, p. 58-9) highlights the variation in the location of workers from different sectors across the local authorities of Wales; for example, 14 per cent of the employed population in Powys work in agriculture, forestry and fishing, a sector which represents less than 1% of employment in Swansea (ibid). The kinds of employment across local authorities and their level of exposure to economic downturn may be factors in the level of volatility, depending on how the tax were designed.
- 4.12 The level of taxpayer incomes are also different in Wales to the rest of the UK, particularly for the highest paid. The highest one percent of earners in Wales earn an average of £94,600, compared to £153,400 in the rest of the UK (ibid, p. 22). This means that incomes are more evenly distributed in Wales (ibid, p. 23).
- 4.13 Further research would be needed to determine whether the choice of tax design is vulnerable to employment income fluctuations and volatility, or whether this can be designed-out from the outset. The economic impact of the Covid-19 pandemic remains to be seen, but represents an example of the impact that job losses and industry closures could have on the types of incomes people would receive. If susceptibility to volatility can be designed-out, the mix of income types which make up the tax base would still be important as these could change over time.
- 4.14 Employment encompasses a number of different statuses, including part-time, agency and zero-hours workers. The nature of the current labour market will make income from employment a more complicated indicator of ability to pay than it once was, given the prevalence of variable and insecure work. Fewer people can now predict a fixed monthly or annual salary, and many are engaged in multiple forms and sources of work. ONS analysis of the 2015 Labour Force Survey indicates that, at that time, approximately 40,000 individuals were employed through zero-hours contracts in Wales, equating to 2.8 per cent of the population (ONS 2015)⁹. Although all income from employment would be taxable in a fair

⁹ This figure could be higher or lower as it assumes the respondents had a full understanding of the term zero-hours and the terms of their own contract.

system, the design of a local income tax for Wales will need to take into account the fact that for some, predicting future income or recalling past income is much more difficult. This was frequently highlighted as an issue during interviews.

‘There can be a lot of churn in jobs, lots of fluctuation. Someone could be working on a zero-hours contract in December, busy, lots of work, but come January there may be no work. Fluctuation is a real source of complexity. This is probably more of an issue for younger people.’

- 4.15 This was a key issue for one participant who had been concerned for some time by the mismatch between individuals with variable wages and the fixed timeline of most household bills, like council tax. A potential technological solution to this issue was proposed during interviews:

‘There have been various financial technology ideas about how you might match those things, so that you could maybe smooth people’s fluctuating income so they could cope with some of those fixed costs a bit better. Some banking solutions now calculate an average income over the year and pay the individual a fixed monthly salary on this basis, making it easier for them to budget.’

- 4.16 Variable work will introduce significant complexity into assessments of ability to pay, but with appropriate practical solutions this may not be an impossible problem.

Indicators of ability to pay: income from self-employment

- 4.17 Data from the ONS’ Annual Population Survey indicates that, as of June 2020, there were 205,500 self-employed persons in Wales, which equates to 14.1 per cent of all employed persons (Welsh Government, 2020c). There is no obvious reason why income from self-employment would be treated any differently from income from employment, but many interviewees felt it is likely to be more difficult to assess.
- 4.18 Self-employed national income tax follows a very different timeline compared to PAYE tax (UK Government, 2020), meaning that local authorities who sought to charge local income tax to the self-employed may have to create separate systems of collection or have different stages throughout the financial year. This could introduce complexity into the system, as currently the self-employed are

expected to pay council tax in the same way as anyone else. Bills could be based on income from the previous year, but self-employed income can fluctuate from month to month and year to year. In their research on the relationship between property prices and income, Davies et al (2007) found a relatively high incidence of self-employment in households of low income. As with those in insecure or variable work, the self-employed may face real challenges in predicting their future income, and those in certain industries may be more exposed to periods of economic recession.

- 4.19 For self-employed business owners, taxation of profits depends on whether the business is incorporated. Unincorporated businesses pay tax on profits through personal income tax, whereas limited companies pay tax on profits through corporation tax (Local Government Finance Review Committee, 2006, p. 108). Further information on the number of unincorporated businesses in Wales would be needed to estimate the size of this tax base. Including this form of income in the scope of local income tax may also encourage higher rates of incorporation to avoid the tax. Behavioural changes of this kind will be considered further in section 7.
- 4.20 For both income from employment and self-employment, further decisions would need to be made about how to quantify income. There are choices as to whether the income should be gross or net of national income tax and other deductions, such as student loan repayment and pension contributions. Interview participants with expertise in household finance highlighted that there is some disagreement between researchers of household income about whether to consider income before or after housing expenses, as the level of housing costs vary drastically and can have a significant impact on disposable income. Though this wasn't raised in interviews, the Welsh Government will also need to consider that smaller or larger housing costs are to some extent a personal choice.
- 4.21 Income from employment and self-employment are forms of earned income, which can be contrasted with unearned income sources such as inheritance or interest from savings and investments. The distinction between earned and unearned income can play a major factor in public perceptions of fairness; some people feel that they should be able to keep as much as possible of the income they have earned, meaning unearned income would be taxed more heavily. Although income

from employment and self-employment may seem to be the biggest and most obvious indicators of ability to pay, their status as forms of earned income may reduce public support for their inclusion as an indicator, particularly as their employment income is already taxed through national income tax. It is therefore necessary to also consider forms of unearned income.

Indicators of ability to pay: savings, investments and the interest they generate

- 4.22 Interest from savings and investment dividends would be classed as unearned income. Households who hold considerable cash savings or investments may receive substantial additional income which it may be unfair to exclude in any assessment of their affordability. Savings themselves could also be seen as a financial resource which taxpayers could draw on to pay their share of local taxation.
- 4.23 The interviews gave an insight into the potential complexity of bringing this form of income into the scope of a local income tax:
- ‘[By excluding savings and investments] You avoid the need to involve an enormous number of financial institutions, for example pension funds and banks that may or may not have correct addresses for people, so for a relatively small slither of income you’re probably massively increasing the amount of organisations that have to be involved.’
- 4.24 Where local income tax has been considered in other jurisdictions, taxing income from savings and dividends has been highlighted as problematic. In evidence to the Office of the Deputy Prime minister’s Balance of Funding Review, the Chartered Institute of Public Finance and Accountancy concluded that ‘taxing investment income raises many problems, none of which appear to be capable of being satisfactorily resolved within reasonable cost.’ (Local Government Finance Review Committee, 2006, p. 97). Others have concluded that it would be impossible to bring interest from savings and dividends into the scope of a local income tax without adopting universal tax assessments (Scottish Government, 2008, p. 23).
- 4.25 The amount of savings someone has access to could still be considered as part of an assessment of their ability to pay. The potential impact of this will be considered further in section 6.

Indicators of ability to pay: Universal Credit or legacy benefits

- 4.26 Consideration would also need to be given to whether ability to pay would include income from social security benefits. Wales is currently in a transition phase from the numerous forms of income now referred to as legacy benefits to a combined Universal Credit (UC) system. In May 2019 there were 91,674 households in receipt of UC in Wales (Welsh Government, 2020b, p. 25). It is projected that this will increase to 400,000 households by the end of managed migration, which is due to be completed in 2023 (ibid). Of those who received Council Tax Reduction in 2019-20, 21.6 per cent were UC recipients (Welsh Government, 2020e, p. 3).
- 4.27 Eligibility for UC is determined based on an individual's current income and level of savings, meaning that it is targeted at the lowest earners and those without savings to fall back on (UK Government, 2020b). In designing a local income tax, decisions would need to be made about a minimum level of ability to pay, under which someone is not expected to contribute, much like the tax-free allowance for National Income Tax, or the threshold for eligibility for the current CTRS in Wales. A decision would need to be made as to how maximum awards for UC relate to any minimum income level; this would decide whether those on benefits are expected to pay any local income tax, or whether they are exempt as low earners.
- 4.28 Under the current council tax enforcement system, local authorities who have secured a liability order for arrears are able to make regular deductions from an individual's benefits to repay their arrears over time, with percentage limitations on how much can be deducted (Regulation 44(6) Council Tax (Administration and Enforcement) Regulations 1992). The current approach is therefore not to exclude those on benefits from liability to repay council tax arrears, even where benefits are their primary source of income.
- 4.29 Consideration would also have to be given to how local income tax may interact with the benefit cap which is currently in place in England and Wales (ONS, 2020).

Indicators of ability to pay: retirement income

- 4.30 Although those who have retired will not receive income from employment, the extent of their pension provision varies significantly from person to person. Wales derives a higher share of income tax from pension incomes than the rest of the UK, 20 per cent compared with 15.3 per cent in the rest of the UK (Ifan and Poole,

2018, p. 19). A third of this pension income is from state pensions (ibid). As noted above, pension wealth makes up 52 per cent of total wealth in Wales (ONS, 2019).

4.31 It is important to remember that pension-age citizens are liable to pay council tax currently. How to tax pensioner income may be one of the major issues in the design of a local income tax. One of the main criticisms of the current council tax system, discussed above, is that it is unaffordable for some elderly taxpayers who may have significant property assets but live on a reduced pension income, the group often referred to as 'asset rich, cash poor'. In 2017, the elderly population represented 20.6 per cent of the total population of Wales, compared to an average of 16.7 per cent across OECD countries (OECD 2020b, p. 72). However, it is not known what proportion of the elderly population have problems paying council tax. Many of the decisions on which of the above forms of income and wealth to include as an indicator of ability to pay will dictate how pension income is taxed. If the ability to pay is assessed wholly with reference to employment income, many pensioners may pay nothing at all in local income tax, despite the fact that some may have considerable pensions, significant accumulated property wealth and little to no housing costs. The burden of taxation would have to be reallocated to the working age population, which may be perceived as unfair.

4.32 A number of interview participants expressed doubts over the extent of the problem of the 'asset rich, cash poor':

'It seems to be kind of anecdotal, there's not such a big problem as is often thought. Including pension income in the scope of the tax would keep those pensioners who can pay in the system.'

'Wealth rich, income poor – it is exceptional cases, and with a small amount of relief that could be resolved.'

4.33 The project has highlighted some areas where further research could improve our understanding of which demographics struggle with council tax, and whether pensioners are particularly disadvantaged. If this is confirmed as a significant problem, there would be options to consider specific provision for pensioners, rather than designing the whole of the local income tax to resolve this problem.

4.34 Public perceptions of taxation of pensioners has been assessed in previous research. In a survey conducted as part of the Lyons Inquiry, three quarters of respondents were in agreement that the elderly should automatically pay less

council tax, even if they own their property without a mortgage (2007, p. 242). This suggests some consensus that a fair system of local taxation would shield the elderly from high bills, but it is less clear whether the public would also support this shielding being funded by a shift of liability onto the working age population. Also, public attitudes towards taxation of pensioners may have changed since 2007 and it would be important to test this once again (and for other demographic groups) in designing a new local tax.

- 4.35 This highlights that, as much as previous academic research is useful in the design of a new tax, there is always a risk of discord between what informed commentators or experts perceive to be the fairest indicators of ability to pay, and what the taxpaying public feel should be included (McCluskey, 1998, p. 53). These decisions will be crucial to the success of a local income tax in terms of its revenue potential and its level of public support, but they are difficult decisions. The complexity of defining ability to pay was highlighted in the literature some years ago by the Lyons Inquiry:

‘I am not convinced, for example, that a pensioner household with a relatively modest income but significant savings or housing equity, is less able to pay than a young family with a larger income but no other assets. In this light I have some concerns about whether abandoning property taxes for income taxes would be fair; in practice this might simply replace one sort of perceived fairness with another.’ (p. 263)

- 4.36 One interviewee with experience of research on pensioner finances highlighted that there is likely to be variation in income across the elderly population, but that overall their finances have improved in recent years:

‘We have seen poverty amongst the older population reduce over time, that might have been an historical anomaly, but actually on aggregate older people have been better able to pay because they have been somewhat better off. That’s the aggregate picture, but there will be people in there who will be struggling.’

- 4.37 The choices made about indicators of ability to pay will inevitably lead to comparison between different demographic groups, which supports the need for further econometric research into the potential financial impacts of a local income tax in Wales.

Indicators of ability to pay: individual or household level assessment?

- 4.38 Under the current council tax system a bill is issued to the adult occupiers of each chargeable property, hereafter referred to as the 'household'. It is assumed that two or more adults live in the property, and any deviation from this household structure, such as a single person living alone, can be the basis of a reduction in the amount payable (Welsh Government 2020d). The fact that the household is the unit of taxation creates a clear link between the amount paid in council tax and the funding of local services where those householders live and vote (Lyons Inquiry, 2007, p. 265).
- 4.39 If a local income tax were to be introduced, a decision would need to be made about whether to continue using the household as the unit of taxation, or whether to switch to issuing bills to each adult, with the potential that one household could receive multiple bills. The Community Charge was linked to an individual rather than a property, and the experience of administering that tax highlighted that a large number of people relocate each year, potentially to new local authority areas (Local Government Finance Review Committee, 2006, p. 102).
- 4.40 Interviewees felt that a household level tax would be appropriate because of the way in which services are experienced, but also saw administrative challenges for households with a number of adults.
- 'At least some of the services that are currently paid for through council tax are experienced at a household level, so things like policing and refuse. It probably makes more sense to do it at a household level.'
- 'For ability to pay you need to look wider than the liable person, you need to look at the household. That's when it starts to get messy, for example where there are non-dependant adults in the household. The more adults in the house, the more circumstances you'd need to consider, the more you factor in, the more difficult it gets, the more nuance there is.'
- 4.41 Maintaining the household as the chargeable unit would preserve the approach of council tax that the type of housing tenure (i.e. whether the property is owned or rented) is of no consequence for tax purposes. This would be in contrast with other alternative systems of local taxation, such as Land Value Tax, the liability for which would likely fall on landowners (Ap Gwilym et al, 2020, p. 30-31). Recent research shows that 67 per cent of households in Wales are owner-occupied, 21 per cent

are rented social housing and 11 per cent are privately rented (Adam et al, 2020, p 61).

- 4.42 Keeping the chargeable unit as the household would also be in line with the approach taken to assessment of UC entitlement, which takes account of the applicant's earnings as well as any other income that their household receives. There would be a further administrative benefit as the number of taxable properties each local authority is responsible for billing would only fluctuate when new properties are built. By contrast, if the individual were the taxable unit, there could be almost constant variation in the numbers of taxpayers moving in and out of a local authority area.
- 4.43 Not all households of multiple occupiers have any familial relationship; for example, there are houses in multiple occupancy (HMOs) across Wales where professionals cohabit and share household bills, but do not necessarily live as a unit where all sources of income are shared. This could cause a problem where one occupant was a very high earner, meaning the household's bill for local income tax would be inflated even though the financial resources of the household may not be pooled. Between 2018 and 2019, there were 14,783 HMO properties known to local authorities across Wales, but it is estimated that there are likely to be 19,578 in total (Statistics for Wales, 2020, p. 12). 43 per cent of known HMO properties are in Cardiff, which may be influenced by the high student population (ibid). For this kind of household, an option to be assessed as an individual in appropriate circumstances may need to be considered.
- 4.44 Internationally it is most common for countries who use a local income tax to charge each individual, rather than the household. This overlaps with, and is to some extent reliant upon, the tendency to require universal self-assessment tax returns and the fact that local income tax is deducted from wages at source.
- 4.45 Charging an individual rather than a household would undoubtedly make a local income tax more visible to taxpayers than council tax (Commission on Local Tax Reform, 2015, p. 53), as houses with more than one adult would receive multiple bills which could be perceived as more burdensome, even if their combined tax bill was the same or less than under council tax.
- 4.46 In their modelling of the potential of local income tax both the Scottish Government and the Lyons Inquiry in England made the assumption that the tax would be

linked to the address on the basis that this would preserve the strong link between tax paid and services delivered in the area in which people live and vote (Commission on Local Tax Reform, 2015, p. 45; Lyon, 2007, p. 265). However, both pieces of research were primarily focused on local income tax collected at source through PAYE; a distinction needs to be made between a tax which is linked to someone's address, in which each adult at the address would be individually billed, and one where collective affordability would be assessed and a household level bill issued.

- 4.47 Much time has been dedicated in previous research to considering the extent of the administrative burden on employers, as currently employees are not required to report any change of address to HMRC (Chartered Institute of Public Finance and Accountancy, 2004, p. 6). However, such a system would not be possible in the form of a local tax in Wales due to the present devolution settlement. A system which was locally assessed and collected, although blessed with its own complications, would avoid these additional administrative challenges.

Indicators of ability to pay: household circumstances

- 4.48 Almost all stakeholders identified that there is more to ability to pay than income alone. The circumstances of a household influence their everyday costs and the level of disposable income they have. For example, living costs can be higher for households with children, and disabled individuals may have additional costs associated with their disability. Under the current council tax, exemptions and discounts introduce some consideration of circumstances, but these are reactive, and most are reliant on the individual to apply and provide evidence of eligibility. If some consideration of circumstances as indicators of ability to pay was built into the original assessment of liability, this would avoid the need for some of the reactive reductions and exemptions, and ensure that the original bill was a full reflection of that household's ability to pay. When the Scottish Government modelled the potential of a local income tax, assessment of circumstances was seen as a key consideration (Commission on Local Tax Reform, 2015, p. 22). However, many participants expressed concerns about how circumstances could be fairly assessed.

‘These circumstantial factors complicate things further, because who decides what factors you should take into account? There aren't a set of neutral

factors. Because of this, you may start to make normative judgements about the cost of children, etc.'

4.49 This highlights the difficulty of designing indicators of ability to pay, as factors which are supported in principle may be difficult to implement in practice.

4.50 Others were concerned whether circumstances should be the concern of a tax, as opposed to a benefit or other form of welfare support.

'Tax is not concerned with circumstances, unless you're thinking about reliefs. You go to work, you get taxed, that rate of tax does not care about who lives in your household. There are some anomalies in the benefits system, where you are judged based on your household, but these are exceptions.'

4.51 It would be beneficial to have a full picture of a household's income, but this could be equivalised to take into account the number of people living in that household (ONS, 2020, p. 19). This acknowledges the fact that households with many members are likely to need a higher income to achieve the same standard of living as households with fewer members (ibid). It could be complex, but guidance could be sought from the current social security system which already applies similar measures, for example when calculating benefits entitlements for single adults, in comparison with families with children. It would be a policy choice for the Welsh Government as to whether a local tax contribution should be concerned about standards of living.

4.52 Any attempt to design a system which takes into account circumstances would benefit from greater knowledge of the different family structures in households across Wales. Recent analysis of the Understanding Society survey dataset indicates that multi-family households make up 24 per cent of all households in Wales, three quarters of which are intergenerational families, for example, elderly parents living with their adult children (Adam et al, 2020, p. 52-53). To best understand circumstances, local income tax could be designed to assess affordability of a diverse range of households. However, linking personal circumstances to the tax system can be controversial, and care would need to be taken to avoid the workings of the tax system indirectly incentivising any particular household makeup over others.

4.53 If the system were designed without an inclusion of circumstances, it arguably would not achieve the goal of reflecting ability to pay. If someone's income suddenly dropped, for example as a result of redundancy, a system based on income would be able to adapt to reduce the burden of their tax during the period of reduced income. However, in a situation where income remained the same, but a major life event occurred causing increased living costs, the individual's tax liability would not be altered (Commission on Local Tax Reform, 2015, p. 71). It was suggested during interviews that instead of viewing certain circumstances as a reduction in affordability, the perspective should be that a minimum standard of living should be achievable for all, and that local taxation should not be so high as to degrade this minimum standard.

'We should try to make sure that local taxation doesn't erode people's income below a certain point which means they can preserve a basic, minimum standard of living. A minimum income standard would take into account the family composition, and protect some of that expenditure to make sure they had a minimum standard of living.'

4.54 Both the CTRS and Housing Benefit scheme currently account for wider household circumstances which go beyond income levels when assessing eligibility (ibid, p. 42). The benefits system frequently uses what is known as 'passporting', where entitlement to a particular benefit is alone considered sufficient to bypass a more detailed needs assessment (ibid). There may be lessons to learn from the current social security system in terms of designing a system which could account for household circumstances, particularly as local income tax will need to establish links with the wider benefits system.

4.55 Some participants warned about overextending the aims of a local income tax, and stressed that it should be thought of as part of a wider system.

'It's the job of the government to be sensitive to ability to pay and needs, but that doesn't mean it's the job of a local tax to be sensitive to things like the associated costs of being disabled. We have disability benefits for that purpose. You don't need to have all parts of the system trying to achieve all objectives at the same time. You need to focus on the fairness of the system as a whole, not necessarily the fairness of each individual component of it.'

4.56 This raises the question of whether a local income tax is best suited to a whole-systems approach to fairness, which may require collaboration with UK government, or more localised objectives.

Continued need for exemptions, discounts, disregards and reductions?

4.57 Under the current council tax system there are a wide range of discounts, exemptions and disregarded people, some of which exist to protect those who have a reduced ability to pay, and which reflects the challenges of billing those who do not have the means to pay (Commission on Local Tax Reform, 2015, p. 29). A key conclusion from interviews was that protections of this kind could be built into local taxation from the outset through local income tax. Many interviewees agreed that this was a key advantage of a local income tax if the connection to ability to pay could be achieved.

‘At the moment the discounts and the reduction schemes are playing that kind of role, you’re retrofitting it to make council tax affordable. If you could get to a position that was prospective rather than retrospective that would be really good, and you’d remove some of the existing complexity.’

4.58 There would be no need to retain the single adult discount, as a household’s bill would be based on its ability to pay. The single adult discount is often assumed to describe only single people who are living alone, however, it comprises a broad range of household compositions as it simply means there is one liable adult present. For example, other adults may be disregarded or there could be children or other dependents living in the property. For those living alone though, abolishing the discount could combat the inefficient use of property which can be perpetuated under the current council tax system, and avoid situations where high-earning single adults receive a reduced bill despite having the ability to pay more (Adam et al, 2020, p. 18-19). It has been argued that the single adult discount makes significant assumptions about the financial position of single people (Kenway and Panell, 2003, p. 7).

4.59 Households occupied solely by students receive a full exemption from council tax, which some criticise given their use of local services (Lyons, 2007, p. 244). Submissions to the Lyons Inquiry highlighted some tensions between those resident in areas with a high concentration of student accommodation who were aggrieved at the thought of funding the increased need for things like refuse

collection, whilst students were exempt (ibid). Some have suggested that landlords of student accommodation could contribute to the council tax which would have been payable if the accommodation was not occupied by students, but this may not fit within a system of local income tax as the tax would be linked to the ability to pay of the occupiers in all other cases.

4.60 When the Scottish Government asked about the continued need for exemptions or discounts in its public consultation on local income tax, 50 per cent of respondents felt exemptions or discounts should not continue (2008, p. 25). Of those who felt discounts should continue, 51 per cent were in the age range 18-34, and 23 per cent were aged over 65. Those who were in favour of discounts were asked to state which groups should receive them; the most popular answers were pensioners (24 per cent), disabled people or those with a long-term illness (15 per cent) and the low paid (13 per cent) (ibid).

4.61 Many interviewees described the current system of discounts and reductions as something akin to a minimum income threshold for liability to local taxation. The idea of designing a local income tax with a fixed threshold was discussed, with many seeing the benefit of such an idea as it would mean many of those who currently receive reductions and exemptions would naturally fall out of the scope of the tax.

‘It’s likely that a lot of people will just naturally fall out of the scope of a local income tax because they can’t afford to pay. That actually might be one of the benefits of a local income tax in that, if there is an income threshold, people will just fall out of the system and there’d be no argument. So there might not be any need for the complex reductions structure. That is a big administrative cost of council tax, dealing with all the ‘wrinkles’ in the system.’

4.62 Interviewees identified similarities between the current CTRS and the possibilities of a local income tax, in terms of shielding the lowest-paid from liability:

‘We already have, to some extent, a local income tax in reality for those in receipt of CTRS; the more they earn, the more they will be expected to pay.’

4.63 Care would need to be taken in setting the level of any minimum income threshold, but some participants felt this may be a good opportunity to tailor the threshold to the fiscal realities of Wales.

‘If you were designing a system for Wales you wouldn’t have it so high because so many people are not paying income tax, so you have a tax that’s focused on a very small share of your population, so it’s not that responsive. But it’s not a blank slate, so if you are going to make what would be quite a significant change, you’d have to have a very good case as to why there should be a lower personal allowance.’

4.64 This suggests that the threshold could be set lower than for the rest of the UK to reflect the lower average earnings in Wales, therefore spreading the cost of the tax across a wider tax base.

4.65 One issue with a minimum income threshold would be ensuring that the system kept track of changes in an individual’s income.

‘A minimum income threshold would work in theory, but how do you ensure that you capture changes in people’s circumstances? What happens when they start to earn more? With income tax you don’t pay tax on the first £12,500 of your income, and in theory anyone under that level is not part of the income tax system, but HMRC still monitors their income and knows when they start to earn more.’

4.66 Without some form of information sharing or alerts for a change in income, local authorities may have to rely on each taxpayer to proactively inform them of changes in their circumstances, or be content that changes are captured on an annual basis.

4.67 A minimum income threshold would need to be set at household level, to avoid giving large incentives to multi-adult households in comparison with single households. For example, under current national income tax, tax free allowances benefit multi-adult households in that two adults earning a combined total of £50,000 will pay tax on earnings of £25,000, whereas a single adult who earns £50,000 will pay tax on £37,500 (ibid, p. 34). This could also impact HMOs.

Key points:

- The design of a local income tax requires careful consideration of what should be indicators of ability to pay. These indicators need to be reliable and accurate.
- There are many types of income and wealth which could influence someone's ability to pay, and deciding which to include may be the most challenging aspect of designing a local income tax.
- Income from employment will be the major indicator of ability to pay, but variable working makes this more complicated to assess.
- Self-employed income should be treated the same as income from employment, but the different chronology of taxation of self-employed income presents challenges.
- Savings and investments could be considered a factor in ability to pay.
- The inclusion of income from Universal Credit or other benefits prompts consideration of a minimum income threshold for local income tax.
- Taxation of pensioners may be crucial in the perception of local income tax, given some criticisms of council tax being unfair for those with reduced income later in life, though the extent of this requires further analysis. If pension income was not included in the scope of an assessment of ability to pay, this will inevitably shift the burden of taxation onto the working-age population.
- The literature and interviewees put forward many reasons for bills to remain at the household level, rather than switching to an individual basis, but this is at odds with the international approach.
- Ability to pay could be based on more than income alone, but it may be difficult to accommodate all potential circumstances. Some interviewees felt that it was not the role of a tax to be sensitive to household circumstances.
- A key benefit of a local income tax may be the ability to design in from the outset things which are normally dealt with through discounts and exemptions, such as student status. This relates to the idea of a minimum income level, which would cause many who currently receive discounts and exemptions to naturally fall out of the system.

Further research required:

- Investigate further the kinds of employment which contribute most to the tax base in Wales, to understand the level of potential volatility during economic downturns.
- Investigate the extent to which citizens of pension age struggle to pay council tax, using these findings to inform the definition of ability to pay for local income tax and to decide whether alternative provision would be required for this demographic.

How to assess ability to pay

- 4.68 Following the comparative research on international uses of local income tax detailed above, the focus of the interviews was the feasibility of a local income tax for Wales which would be set and administered by local authorities. Discussions often included the option of national collection through PAYE or through agencies such as HMRC, but participants were asked to provide their views on a local system to better understand whether this would be possible. This reflects the fact that a 'piggy-back' tax, collected at source, would not be possible under the current devolution settlement.
- 4.69 Two main options were proposed to interviewees; the first was a system of data sharing between agencies such as HMRC or the Department for Work and Pensions (DWP), and the local authorities of Wales. The second was a purely locally conducted means-assessment (in reality, the actual model could be somewhere between the both of these options as is currently the case for the administration of CTRS).
- 4.70 The majority of participants felt that data sharing seemed the most obvious starting point because of the large amount of information on income which is held by agencies such as HMRC and DWP. However, many expressed concerns about how possible it would be to secure access to HMRC or DWP data, and felt it could present challenges in terms of technology and data protection. Some reflected on challenges in previous pilot projects with HMRC:

‘There are some trials underway, but it’s [data sharing] at HMRC’s control.... To make a taxation system work effectively, you need open access for interrogation.’

- 4.71 The second option discussed was purely locally conducted means-assessment and collection, involving local authorities collecting information from their own taxpayers on their financial situations and using this to calculate their liability.
- 4.72 Local authorities already have experience of assessing income and expenditure when dealing with council tax arrears and their repayment. Some interviewees were positive about the existing expertise of local authorities in terms of assessing income, but saw the extent of scaling up required as a significant problem which may not be achievable without new data sharing arrangements.

‘Within local authorities at the moment you’ve got: people that assess housing benefit, council tax reduction, council tax discount, free school meals, adult social care, etc. So there are people who are used to understanding a person’s income and situation and working out an assessment from there. You’ve got the core there, but it’s a case of how big you scaled it up and how complex you made it.’

‘Local authorities do currently have some idea of a portion of council tax payers and their incomes at the moment, but how feasible that would be to do for the whole population of 1.3 million properties rather than the 300,000 properties they currently assess would be quite a challenge without some sort of data sharing arrangements.’

- 4.73 Others felt that there could be problems with the nature of information local authorities would need to collect, more so than the scale.

‘When you look at CTRS, you’re looking at households which are engaged with the wider UK social security system, but I see that as being a very different cohort and degree of understanding to income tax payers at the other end of the wage spectrum, who will have much more sophisticated personal finances and much more diverse sources of income, potentially. Current knowledge and understanding is on the benefits system, and it would be a bit of an ask to get local authority expertise good enough to forensically go through the tax avoidance type accounting that higher earners might be tempted to engage in.’

- 4.74 However, Mikesell (2003, p. 9) warns against seeing a need for training or development as an impossible challenge, because in reality it is inevitable that

current expertise and capacity would not be directly transferable to any new system.

‘regional or local governments are unlikely to have full capacity to administer their own taxes if they have never actually done it before and central governments are reluctant to permit self-administration without demonstrated administrative capacity...the question should be the extent to which they could become capable of the tasks, not whether they are currently prepared to do the work’ (2003, p. 9).

4.75 One major decision will be what time period will be relevant for assessing income. This could be based on weekly, monthly or annual income. Annual income would be more challenging for the self-employed and those who work in variable or insecure work to predict, but would be less burdensome than asking for more regular information. Income could be reported retrospectively, or predicted for the year ahead. Whichever option was chosen, there may be a need for some reconciliation at the end of the billing period, as is done with national income tax for the self-employed, but this method of ensuring the accuracy of bills introduces further complexity and could be problematic for lower earners.

‘If you have to make adjustments at the end of the year for example, that becomes much more of a problem for people at the lower end of the income spectrum than those at the higher end, because they may be faced with paying additional amounts that were unforeseen. This was seen with the working tax credits system, where the need for adjustments was much higher than expected. Approximating first and reconciling later is something that you have to be very careful about.’

4.76 Whichever forms of income are considered, the information from which local authorities decide liability will need to be accurate, reliable and up to date. This may be the most challenging aspect of linking the level of the tax to ability to pay, as it creates an incentive for people to downplay their level of income in order to reduce their liability to local income tax. Consideration would need to be given to some kind of auditing of the financial details provided by taxpayers to counter this incentive, and there is a choice for this mechanism to be independent of government or local authorities. One participant highlighted that inaccurate reporting is not always motivated by deception.

‘You’ll get some people, I would assume, that would deliberately underreport their income. People might also simply be mistaken. People on lower ends of the income scale, there is a sense of shame, they might over report because they may find it difficult to be asked.’

- 4.77 Taxpayers may also object to a system which requires them to submit details of their income to their local authority, because they find it intrusive or simply too much of a burden, with the burden potentially falling unevenly.

‘It’s questionable how much taxpayers would be comfortable to share their financial information. You could require people to do it, but for a local tax of any kind it’s preferable that people contribute to local services by consent.’

‘We know that people who are lower income, or in poverty, don’t apply for as many reliefs or other things as they should. Opting in to something adds a burden to people, especially if you are poor and you already have other burdens in your life. The more we can remove that burden the better, particularly for those on lower incomes.’

- 4.78 Requiring taxpayers to submit their financial information would be a significant practical change and it would move away from an established culture that the majority of taxpayers don’t have to engage with the tax system at all.

‘Generally, for people on PAYE, which is still the dominant system, our engagement with the tax system is almost nothing until we have some kind of issue or we get to retirement. We need to start from a benchmark that most people in the UK know virtually nothing about how the tax system works and don’t have any engagement with it. Making us engage with it at a large scale is probably not going to work.’

- 4.79 One existing method of collecting information about someone’s income and circumstances is the Standard Financial Statement (SFS), which is used across financial advice charities and organisations¹⁰. The SFS is an income and expenditure tool which was developed collaboratively by the Money and Pension Service and a range of representatives from across debt advice and the credit sector, so enjoys multi-agency support. It is used primarily when assisting

¹⁰ The Standard Financial Statement is not publicly available, but a descriptive overview can be found at [Money Advice Service](#).

individuals with personal debts to agree a manageable and realistic repayment plan. It has in-built spending guidelines which are based on levels of expenditure observed among typical households in the UK. It also includes allowances for the composition of the household, such as the number of children. The figures and guidelines are updated annually to reflect changes in expenditure patterns, based on the ONS Food and Living Costs survey and the Consumer Price Index (Money Advice Service, 2020). The SFS also includes a category for regular savings, which aims to engender a savings behaviour which may increase financial resilience to unexpected income shocks.

4.80 However, it could be argued that the SFS is more detailed than a standard self-assessment tax return, and therefore more onerous even than moving to universal self-assessments in Wales, which would be a dramatic change in itself. Administration of this kind could also be costly. It is estimated that taxes cost three and a half times more to collect where an annual return is required compared with tax collected through PAYE (Chartered Institute of Public Finance and Accountancy, 2004, p. 44).

4.81 A number of participants offered the SFS as a suggestion during interviews, whereas others were asked for their views on it. Some felt that the statement would need significant changes to make it applicable to individuals across the spectrum, and that it may be very challenging to create something with such a broad application.

‘In theory it sounds great, but the only issue is that it’s been designed mainly for citizens who have particular debt problems. Because of this the form might need tweaking for those households that aren’t in debt. If I’m a debt adviser, I would be focusing on immediate assets and cash to resolve the debts. I would have less focus on other sources of income, because I would assume that they don’t have things like investments. It could be insensitive to ask someone in severe debt what portfolio of shares or investments they have. I would have doubts over how suitable that form is for all kinds of household, and whether you can get a one size fits all.’

4.82 Others reflected on some difficulties that the SFS had created for local authorities, and a feeling that the financial assumptions it was based on were overly generous and out of line with the wider social security system.

'The difficulty we find with the SFS is that some of the minimum amounts are often higher than what someone on benefits is entitled to anyway - it's a very generous assessment process. The amount you allow for certain costs doesn't always bear relevance to the benefits system. So someone on means tested benefits could go through the form and fail on every aspect, because their income is too low, which has already been set by a government. So, they're completely out of tangent with each other. It's raised more questions than it's answered. It hasn't been accepted by all local authorities, because if everybody used it nobody would ever be making a council tax arrears payment.'

- 4.83 Consideration would need to be given to whether taxpayers would need to evidence the information they provide about their finances. Interviewees expressed concerns about self-certification of income as well as the quality of information that would be provided if it is based on the taxpayer's memory.

'There is definitely a question of people being able and willing to give their financial information. One of the issues in debt advice and debt management is that the SFS has to be based on people's memory, you're relying on people's ability to keep records. There are definitely questions over willingness and also quality of information.'

'In a different sphere, before the [2008] financial crisis people who were self-employed were able to self-certify their income for the purposes of mortgages, which led to all sorts of issues with people borrowing far more than was ever affordable. There are definitely lessons there from history that self-certification is not a great system.'

- 4.84 Whichever form of administration was chosen, more information would be needed about the costs this would generate to avoid having a fair system which is unaffordable.

'You need to think about the cost of the administration of any tax, because yes, you might be making something more equitable, you might be making it more fair, but if there's a very high cost in its administration and enforcement, you can take away from some of those goals.'

Key Points:

- Interview discussion focused on two main options: data sharing between agencies such as HMRC or DWP and local authorities, or purely local assessment and collection.
- Data sharing was seen as an obvious initial option, but one which would present challenges. It is difficult to reach agreement for such arrangements and to make them reciprocal.
- In terms of purely local assessment and collection, positive views were expressed about the existing abilities of local authorities to assess finances, but there were reservations over the potential increase in the scale of the work and the different types of income which would need to be assessed to get a full picture.
- What time period to assess income over will be important as this will influence the chronology of collections and the predictability of revenue.
- If income is self-reported this introduces a risk of inaccurate reporting. This will require some form of auditing process.
- There is a need to be realistic about how large a societal and cultural change a local income tax would be in terms of requiring reporting of income, given that most people in Wales currently have very little interaction with the tax system. Reporting could be perceived as burdensome or intrusive, so care would need to be taken in the messaging which accompanied this kind of change.
- Existing tools such as the Standard Financial Statement are used to assess household finance, but interviewees doubted whether it is universally applicable and questioned the assumptions it makes about living costs which may be inconsistent with the wider social security system.
- Overall, local assessment and collection will only be viable if the costs do not outweigh the benefits in terms of revenue yield and overall fairness to taxpayers.

Further research required:

- Consult local authorities to understand their views on the feasibility of local income tax, but only once a clear set of options for its administration have been developed. The focus of this consultation should be the practical challenges which would need to be overcome for local authorities to successfully transition to and administer a local income tax.
- Investigate in greater detail the feasibility of data sharing in relation to assessing ability to pay, involving key stakeholders.

Local discretion in setting tax rates

4.85 Tax rates are a key aspect of potential tax yield, along with the size of the tax base and economic conditions (Gibb and Christie, 2015, p. 14). In designing a local income tax, a key decision would be how to set the tax rate; there could be a standard rate for all local authorities, or they could be given the discretion to set their own rate, creating variation across Wales. This would be a key consideration in setting the parameters of fiscal decentralisation and local autonomy in Wales. In the following section consideration will be given to some of the advantages and disadvantages of either option.

4.86 Kitchen and Slack (2003) see tax rate discretion as crucial for local authorities to achieve local autonomy and accountability (p.2224-5). If local authorities had discretion and decided to increase or decrease their annual rate, it would be for them to justify any impact on funding of services in the local area. This has the potential to increase the accountability of local authorities (Lotz, 2012, p. 12). It could also strengthen the local nature of the tax, rather than it being perceived as a new national tax (Local Government Finance Review Committee, 2006, p. 97). In addition, provided economic conditions are favourable, because of the fact that the tax is linked to income, there may be less need to increase rates year on year (Welsh Government, 2016, p. 37), though this would depend on the spending needs of the authority, and how the annual budget-setting process for local authorities was designed. Many participants saw discretion over the tax rate as crucial to the success of a local income tax, and stressed the incentives associated with local discretion to improve the area and enjoy the benefits of growth:

‘A core assumption of this would need to be that local authorities retain the responsibility and accountability for setting the rate, because if you take that away there’s not much of a role for the local authority at all. It goes to the core of the rationale for local government. It’s highly symbolic, even if rates don’t actually vary much, that they have the discretion to vary it.’

‘A local income tax could incentivise local authorities to improve the lot of their residents, to improve opportunities and get people into higher paid jobs, and therefore get more money back.’

- 4.87 As highlighted in section 3, it is very common in countries which use local income tax for there to be a variable rate between local authorities. The majority of the literature which discusses rates of local income tax relates to systems where the tax is collected at source alongside national income tax. The major issue identified with this kind of system is the complexity of having a different tax code for each local authority area, and the need to have up to date information about each taxpayer’s address at all times. In Scotland it was seen as an unacceptable burden on employers to make the significant changes to their payroll processes that a variable local rate would require (Local Government Finance Review Committee, 2006, p. 104). As an at-source local income tax is not currently an option for Wales, these issues would not be relevant; each local authority would collect the tax due from their own taxpayers, rather than involving national agencies. This could make variable rates more achievable in comparison with systems which collect at source.
- 4.88 The Scottish Government also sought to understand the comparative costs of a nationally set or locally variable local income tax (ibid, p. 106), but these estimates are of little use to the Welsh context as they focus on costs for HMRC, DWP and employers, rather than local authorities as the administrators of the local income tax. Wales would need to conduct its own estimates of costs, which would benefit from a comparison of the difference in costs for a locally variable rate or a fixed national rate.
- 4.89 From a theoretical perspective, Mikesell (2003), in his analysis of international experiences of local taxation, sees local tax authorities as ‘insulated chambers of experimentation’ for tax administration, benefitting from nimbleness in taking

innovative approaches in comparison with national government. The impact of confusion or mistakes in local tax reform can be mitigated to smaller areas (ibid, p. 6), and they are also potentially more in tune with local markets, business practices and 'other local peculiarities' (ibid, p. 7). There may be further benefits of speed and control as the local authority can use funds from a local income tax as soon as payment is made by the taxpayer, rather than waiting for allocation of taxes collected nationally (ibid).

- 4.90 A number of other countries which use local income taxes allow local authorities to set the tax rate. In Belgium, Denmark, Finland, Italy, Spain and Sweden local rates are variable, with different levels of discretion in each country (Loughlin and Martin, 2004b, pp. 9-10). In some cases, a tension persists between national and local governments, for example in Sweden, where central government imposed maximum rates on local governments between 1990 and 2000 (OECD, 2013, p. 107-108). In Denmark there are careful negotiations every year; local government associations recommend to their members not to increase tax rates in return for assurances about the size of general-purpose grants from central government (OECD, 2006, p. 60). These relationships require pragmatic management to avoid significant conflict (Loughlin and Martin, 2004a, p.5), but OECD data suggests that the overall variation in local rates is declining over time (Lotz, 2012, pp. 13-14).
- 4.91 If local authorities in Wales were given the discretion to set the tax rate, consideration would need to be given to whether minimum or maximum rates would need to be imposed (Loughlin and Martin, 2004b, p. 36-37). The Norwegian system highlights that maximum rates can be problematic; local authorities may feel that if they do not match the maximum rate they could be perceived by central government as having enough funding, which may influence the equalisation system or central grants (Lotz, 2012, p. 15). Therefore, imposing a maximum tax rate may lead to the disappearance of variation in tax rates as authorities merge towards the maximum, to some extent defeating the object of introducing this discretion in the first place (ibid, p. 17). One interview participant felt that the level of variation should be limited:

'You'd want to have a very tight band, maybe 0.5-1 per cent range of variation, because otherwise you're going to replicate some of the regional inequality effects, with areas that have a poor tax base being pressured into

raising tax rates to claw back some revenues. A small range of discretion would also limit some of the potential behavioural responses that could be associated with this kind of tax. There'd have to be some equalisation, and the degree to which that happens would be a political decision.'

4.92 When the Scottish Government conducted a survey on potential features of a local income tax, participants were asked to indicate their views on a 3 per cent flat rate for all local authorities. 49 per cent of respondents felt that this rate was 'about right', with 26 per cent feeling it was too high and 16 per cent feeling that it was too low (Scottish Government, 2008, pp. 10-11). The majority of the sample (57 per cent) preferred a rate which would be set nationally rather than locally (ibid, pp. 16-17, with 41 per cent strongly disagreeing that it was important for local authorities to have tax-setting powers (ibid, p. 48)¹¹. Similar surveys would be useful in Wales to understand public views on both the rate of tax and whether it should be variable.

4.93 Whether the rate is fixed nationally or varies locally, there will still be a need for equalisation of revenues across local authorities (Local Government Finance Review Committee, 2006, p. 106). A fixed rate will raise much more in areas of high income than in deprived areas (Loughlin and Martin, 2004b, p. 30). This perpetuates a problem of council tax, where parts of Wales such as Blaenau Gwent have very high band D charges because average property values are low. When this was discussed during interviews, it became clear that it would be challenging to agree levels of equalisation as this could undo some of the benefits of localism and rate discretion:

'To have some incentive effects, you wouldn't want to fully offset changes in tax bases because then local authorities would have no incentives to improve the lot of their residents. If a local industry collapses causing job losses, you'd want to top up their finances but not fully, to avoid removing all incentives. You may also need to have some additional financial flexibilities for councils. They probably would want to hold slightly higher reserves if

¹¹ For all three of these questions, between 9-10 per cent answered 'don't know'; it needs to be borne in mind that a fair amount of those surveyed either had no strong views or may not have understood the implication of the question, which could affect the quality of the data. This should be factored into the design of any surveys in Wales.

they've got more risky funding streams, you may want to think about them having slightly higher borrowing powers.'

4.94 This highlights that local discretion may need to be bolstered by additional funding options to keep responsibility at a local level, before recourse is made to national funding.

Key points:

- The theoretical literature supports local authorities having discretion for their own tax rate to promote responsibility and encourage them to improve the prospects of their residents. Many interview participants also saw this is a key potential benefit of local income tax, both practically and symbolically.
- Some suggested that variation should be limited to a small band to avoid large inequalities, and highlighted that the actual rates may converge over time to a point where there is little actual variation across Wales.
- Local discretion over rates was not popular with the public when the Scottish Government conducted a consultation on local income tax in 2008.
- Equalisation will need to be carefully designed so as not to remove the incentive effects for local authorities to develop their revenue potential.

5. Implementation of a local income tax

5.1 The following section will consider practical aspects of implementing a local income tax in Wales; how local authorities will set spending priorities and predict collection rates, methods for developing and refining the design of local income tax, and the transitional arrangements needed to move from council tax to a local income tax.

Budgeting

5.2 The potential size of the tax base is one key issue, but a local income tax will not be successful unless those revenues can be collected, are predictable and align with the timetables of local authorities. Local authorities in Wales are not permitted to budget for a deficit or surplus in day-to-day spending, so they must set out their spending requirements before the beginning of a financial year and be able to collect those revenues with some certainty. Without predictable collection rates, local authorities may require greater options or discretion to keep financial reserves or borrow funds to smooth out volatile periods (Commission on Local Tax Reform, 2015, p. 69).

5.3 One of the major issues of a local income tax in Wales would be synchronising the system of assessing ability to pay with billing and collections cycles. It would probably be easiest for all taxpayers to report their past earnings, for example for the last year, than try to predict their future earnings, which would undoubtedly require some future reconciliation if actual earnings did not match estimations. The Local Government Finance Review Committee in Scotland did not feel that taxpayers would be able to predict their future income accurately when they considered a local income tax (Local Government Finance Review Committee, 2006). However, basing assessment on past earnings introduces a lag into the system, which could be particularly problematic during any transition from council tax to local income tax.

5.4 Under the present system, taxpayers are notified in February or March about their liability for council tax for the new financial year, commencing on 1 April. Local authorities could amend their standard budget timetables to align with a new taxation system, but this could have knock-on effects on the timing of decisions

about the local government finance settlement, grant funding and local authority choices about services.

- 5.5 Outside of PAYE income, it would not be possible for local authorities to collect income tax on things like self-employed income in the tax year in which that income was earned (Local Government Finance Review Committee, 2006, p. 102). At present, the self-employed are required to complete their self-assessment tax return by 31st January for the previous tax year, with two tax payments made prior to this based on tax payable in the previous tax year. The taxpayer then receives a refund of any overpayment or has to pay additional tax.
- 5.6 Because local income tax could not currently be collected at source through PAYE, the collection rates would not be dependent on the collection performance of HMRC. HMRC estimate that they fail to collect 1.6 per cent of PAYE income and 15.4 per cent of self-assessment income (Commission on Local Tax Reform, 2015, p. 46). Local authorities would therefore benefit from direct responsibility for their own collection rates under a locally assessed tax, as under the current council tax system.
- 5.7 Forecasting of collection rates would also depend on responsiveness of taxpayers in terms of providing their income information on a regular basis. A holding tax could be introduced as an incentive to provide information, but this could be controversial (Chartered Institute of Public Finance and Accountancy, 2004, p. 29). Several stakeholders suggested this during interviews, the consensus being that holding taxes were a sensible idea, but that it would be difficult to set them at an appropriate level.

‘You’d need to build something in that the default charge is the maximum charge, and if you don’t provide your information your bill will always stay at the maximum charge, so it’s in your interest to provide it.’

‘You would need to set the level higher, to avoid people who would be liable for lots of tax opting out of providing their information. It would need to be high enough to incentivise most people to tell you what they actually earn.’

5.8 As was highlighted in Scotland, local authorities cannot be left in a position of having to wait for unknown sums of money at unknown dates (Scottish Government, 2008, p. 55). If a local income tax were introduced in Wales it seems likely that major departures would need to be made from the current timetables of billing and collections to provide sufficient certainty over future revenues. Each change to the current revenues chronology may have knock-on effects in the wider finances of local government.

Key points:

- A key decision for local income tax will be whether to redesign the timelines associated with local taxation to align with the availability of information, or try to fit it into the current system.
- Different forms of income will be paid and assessed at different intervals, introducing delay into the assessment system depending on how ability to pay is defined.
- A holding tax could incentivise taxpayers to provide their financial information, whilst ensuring a predictable yield from those who choose not to opt in to the new system. The rate of a holding tax would be challenging to calculate.

Policy development and piloting

5.9 One option to assess the suitability of a local income tax in practice would be to introduce it in a small number of local authorities, with a framework to evaluate its success after a defined period of time. Blochlig and Vammalle (2012, p. 19) highlight international examples of such pilot projects where comprehensive reform has been contemplated, such as in Canada where sales taxes were trialled in three small provinces before being used nationally.

5.10 However, a number of interview participants expressed concerns about the fairness of pilot schemes. Problems were identified with duplication of work, complexity and the risk of legal challenges on the basis of differential treatment. Some felt that the potential difference in treatment of taxpayers across local authorities was fundamentally unfair.

‘You could have pilots, or incremental roll outs of the new system with changes at each stage, but that would introduce a lot of dual systems which brings complication and administrative burden. It’s also difficult for the public to understand.’

‘There could be risk of legal challenges to pilot projects, and you would have to show that there was good cause for the difference in treatment of taxpayers and that it was proportionate.’

‘I don’t think you can pilot tax, how would it be fair? I’m sure analysts would love to have loads of data, something like a randomised control trial of different tax systems, but it just doesn’t seem ethical. Even though we do trials for medicine, it seems really difficult to do it for taxes.’

- 5.11 One participant summarised the inevitability of some challenges in implementation in exchange for future gains:

‘Transition is to some extent about weathering the storm if you think what you’re doing is right in the long-run.’

- 5.12 This raises the question of who it is that feels that such a reform is the right thing to do. The topic of participatory decision making was raised in interviews in relation to both design and implementation. One participant felt strongly that a reform like a local income tax, which has the potential to be drastic, must be grounded in genuine engagement with the public at the earliest stages so that the design is informed by public views.

‘You should start with small scale citizen’s assemblies, as used for social security reform in Scotland. This avoids a top-down, imposed system. You could start with a design and then have focus groups, that’s a legitimate approach. But, I think it’s more interesting not to start with pre-conceived ideas, but to start from an assumption that to make big change happen, it can’t be done top-down, so you start with a blank piece of paper and take people with you. This has its own tensions, as you will always be working within some parameters and limitations, but it’s remarkable how many ideas, views, knowledge and insights people have. People are really good at looking at things holistically.’

Key points:

- Pilot projects would allow different versions of a local income tax to be trialled to understand how they work in practice, but pilots can introduce unfairness which could be unpopular or open to legal challenge.
- A local income tax which involves the public in all three stages of design, implementation and evaluation may encourage greater support as opposed to a new system which is imposed in a “top-down” style.

Transitional arrangements

- 5.13 Introducing a local income tax would be a substantial change to local government finance, requiring a carefully planned transition over a lengthy period. Although there are many aspects to a successful transition, here consideration will be given to deferral schemes and transitional reliefs.

Deferred implementation/payment

- 5.14 Many interview participants expressed concern about a need to protect those who may see a sudden and significant increase in their bills as a result of a transition to local income tax. Once decisions had been made about the design, the implementation date could be deferred to allow people to adjust to and plan for the new system and any change in their liability. If local income tax removed the need for discounts and exemptions, there would need to be clear communication to those who currently benefit from these schemes about their potential future liability (Commission on Local Tax Reform, 2015, p. 53).
- 5.15 Another option would be to permit certain taxpayers who have equity in their property to defer payment of their bill until the occurrence of some event, such as the sale of their property or their death, at which stage their local tax liability would be paid from the proceeds. This could resolve some criticisms relating to those who are “asset rich but cash poor”, but does raise additional problems such as annual cash-flow and the opportunity for future governments to cancel these agreements. Similar schemes are used in the USA, Canada and Ireland (Adam et al, 2020, p. 88; Ifan and Poole, 2018, p. 73-74).

5.16 However, any form of deferral could be difficult to justify if the goal of the new system was increased fairness; any delay could be seen as an acceptance of the unfairness of the current system (Adam et al, 2020, p. 88), and could impact compliance rates. 55 per cent of those who responded to the Scottish Government's consultation on local income tax did not feel that there should be transitional arrangements at all, which highlights the importance of gauging public attitudes when planning any reform.

Reliefs

5.17 For those who face significant increases, consideration could be given to a relief system to limit the severity of the spike in their liability. Following the council tax revaluation exercise in Wales, a transitional relief scheme was introduced from 2005-2008 to ensure that no household's council tax liability would rise by more than one band in each of the three years following the revaluation (Commission on Local Tax Reform, 2015, p. 54). This was an automatic relief scheme which cost approximately £11 million in its first year. Similar schemes have been used in Northern Ireland following reforms to the Domestic Rating system in 2007, where relief was triggered if a household experienced an increase in their liability of more than 33 per cent (ibid). This scheme cost £32 million over three years. Transitional relief schemes therefore have their associated costs which would need to be factored into the overall expense of the reform.

5.18 Because the goal of a local income tax is to increase fairness and make liability linked to ability to pay, transitional relief schemes have the potential to contradict some of the public communications which would be required to justify the new system. Some may ask why everyone would not pay their true liability from the outset. This would need to be carefully managed to ensure the justification for the reform is not undermined.

5.19 In terms of transitional timescales, this would be influenced by a number of factors unique to Wales. It would be difficult to commence any transitional work in advance of required legislative changes (Chartered Institute of Public Finance and Accountancy, 2004, p. 2). The Local Government Finance Review Committee in Scotland estimated that six years would be a reasonable time period for implementation of a local income tax (2006, p. 110). Lyons saw the introduction of a local income tax as a task for more than one parliamentary term, describing it as

“a significant undertaking and an option for the medium to long term” (2007, p. 272). This estimated duration of reform presents a risk that future governments may not continue the reform project, or make significant changes to it in line with their priorities.

5.20 All transitional reliefs will have to be funded, and their cost factored into the overall potential revenue yield of local income tax. However, *any* new system will require some form of transition with associated cost and complexity; these issues are not unique to a local income tax, but should be factored into decision-making nonetheless. As argued by Gibb and Christie, “anticipating...short run transitional problems in advance of desirable long term impacts is a key way to lay the ground for reform.” (Gibb and Christie 2015; Commission on Local Tax Reform, 2015, p. 53).

Key points:

- The transition from council tax to local income tax needs to be carefully planned, with consideration given to reliefs and other schemes to ease the impact of sharp increases in bills.
- Local authorities could defer the implementation of the scheme to give taxpayers plenty of notice of the changes.
- They could consider payment deferral schemes for those without the cash to make payments as normal.
- Transitional reliefs over a defined period have been used successfully in Wales and Northern Ireland, but come with significant costs.
- The timescale of reform is uncertain, but could be considerable, with previous estimates being longer than a single Senedd term. This may depend on the extent of legislative change required and the ability to achieve political consensus.
- Transition schemes introduce large expenses, but this is not unique to a local income tax and would be a factor in all major tax reform.

6. Predicting the impact of a local income tax

- 6.1 If a local income tax was implemented in Wales, this would need to be carried out in a way which means its impact can be evaluated and consulted upon, allowing any changes at later stages to be informed by evidence. Opportunities for evaluation and priority areas to be evaluated should be key considerations in the design stage, in line with the Welsh Government's obligations under the Wellbeing of Future Generations Act and equalities duties.
- 6.2 As this research represents an initial and conceptual exploration, the scope of this report does not include an analysis of the impacts on taxpayers or on Council revenues. One of the biggest impacts of such a new tax system will be financial and will require a detailed quantitative assessment of impact in due course. It will be crucial to understand which parts of the population of Wales will benefit from a local income tax and who will see an increase in their liability.
- 6.3 The following section will therefore consider two other elements of the potential impact of a local income tax in Wales; behavioural changes and public perception. Both behavioural changes and public perception are factors which should be factored into the design of a local income tax, and actively monitored post-implementation. They both have significant potential to influence the success of a local income tax, and were frequently highlighted by interview participants as crucial considerations.

Behavioural changes

- 6.4 As well as understanding the likely winners and losers from a local income tax, it is crucial to fully consider how taxpayers may react to a new tax. Behavioural changes have been considered in recent years in relation to the new Welsh Rate of Income tax (WRIT) and many of them could also be relevant to a local income tax. Key considerations for a local income tax would be fiscal flight and disincentives to work and save.

Fiscal flight

- 6.5 Fiscal flight describes the behaviour of a taxpayer who changes their permanent address to another tax jurisdiction where the tax rate is more favourable to their circumstances. This phenomenon has attracted considerable academic interest across the world as different tax systems try to predict the impacts of reform, but

evidence is often conflicting. Kay and King (1990) were doubtful of the realities of fiscal flight, arguing that 'for most people, the ties of family, home, culture and language outweigh the fiscal incentives to work in other countries'. This could be particularly true of fiscal flight from Wales, for example, in relation to the importance of the Welsh language and other aspects of Welsh culture.

- 6.6 High levels of fiscal flight have been recorded between the United States of America; where one state's personal income tax is higher than its border states, citizens will emigrate to enjoy a lower tax burden (Northern Ireland Assembly, 2007, p. 11). However, evidence from other OECD countries in Europe is less clear, with some suggesting that rates of fiscal flight are related to national attitudes to social mobility (ibid).
- 6.7 The introduction of a local income tax in Wales would mean very different systems of local taxation between England and Wales, the border of which is often described as porous because of the economic, social and infrastructural overlaps. Nearly 48 per cent of the Welsh population live within 25 miles of this border (Ifan and Poole, 2018, p. 12), and in England, 4.9 million people live within 25 miles of the border with Wales (ibid). This is much greater than the numbers who live in close proximity to the England-Scotland border (Welsh Government, 2016, p. 22). It is therefore important to bear in mind the number of people who may move to, or out of Wales, in response to a divergence in the local taxation systems of these neighbouring nations (ibid). For those who live near the border, it is possible to move between the nations whilst keeping existing employment and without sacrificing social and familial networks (Scottish Parliament, 2015, p. 3).
- 6.8 In previous years Wales has been a net beneficiary of population movement between England and Wales. In 2015-16, 56,950 people moved from England to Wales, whereas 53,170 people moved out of Wales to England (Ifan and Poole, 2018, p. 12). The buoyancy of a local income tax would be improved by population growth, so it is important to fully understand the potential influence of taxation on movement levels.
- 6.9 Students are one of the major demographic groups which currently move between England and Wales. Although more students from England move to Wales each year than vice versa, Wales experiences a net loss of graduates each year once university studies have been completed (ibid). Compared with other devolved

nations, Wales has a low retention rate of graduates, which can affect the future labour force and income levels (ibid), and may have long-term consequences for the yield of a local tax related to income. This should be considered in making decisions about the liability of students under a local income tax in terms of how attractive Wales will be for both students and graduates.

- 6.10 Approximately 90,000 people resident in Wales commute to a place of work in England, more than twice as many who live in England and work in Wales (ibid). If these individuals were faced with a greater liability under local income tax than council tax, the fact that their employment is based in England may persuade them to move their place of residence to avoid increased liability. The majority of these commuters are resident in border local authorities, such as Flintshire, Wrexham, Monmouthshire and Powys (ibid, p. 58). This may mean that the effect of fiscal flight to England may not be felt equally by the local authorities of Wales.
- 6.11 Commuting could also be a factor between local authorities if a variable rate of local income tax was implemented. For example, in local authorities such as Caerphilly, 42,700 employed residents commute out of the local authority area for work, 93 per cent of which go to other areas of Wales (OECD 2020b, p. 70-71).
- 6.12 It is normally assumed that high earners will be the most responsive to tax changes; they may stand to gain considerably under an alternative tax system and also have the means to react (ibid, p. 13), for example to afford the associated costs of relocating and access to financial advice. There may be many people in Wales who have the intention to change their behaviour in response to a new tax system, but structural barriers stop them from actually following through with the behaviour change. They may instead express their views on local taxation through the ballot box (Welsh Government, 2016, p. 22-23; Henrick et al, 2007; Vermeir and Heyndels, 2006; Maarten et al, 2005).
- 6.13 Research by Feld (2001; 2009) on tax migration in Switzerland found that the self-employed were the most likely group to migrate. Liebig et al (2007) also identified a high likelihood for young adults with high earning potential to move to lower tax areas. These two groups are understandably some of the most mobile. An interviewee confirmed that migration tends to be concentrated in certain demographics:

‘International evidence suggests that this [tax migration] is concentrated in the young and the old, the young when they decide where they want to work and the old when they make decisions about where to retire.’

- 6.14 Those who currently benefit from the regressive nature of council tax, such as those who live in very high value properties, may prefer to live in neighbouring nations where council tax persists where they are expected to contribute less in local taxation. Rather than moving to a completely new property, some who already own multiple properties in England and Wales may choose to switch their main residence to the nation which is most tax-favourable (Chartered Institute of Public Finance and Accountancy, 2004, p. 28; Amin Smith et al, 2019b, p. 47).
- 6.15 There could also be an additional dimension of fiscal flight between local authority areas of Wales if local income tax was designed to have a variable rate between local authorities (Local Government Finance Review Committee, 2006, p. 108) (as discussed in Section 4. This was identified in Scotland during their considerations of local income tax; they highlighted the possibility that, over time, high-earners may start to congregate in local authority areas with lower tax rates (Commission on Local Tax Reform, 2015, p. 38). However, they also acknowledged that this is already a feature of the current council tax system in that high-earners have the option to move to local authority areas which have the lowest council tax rates (ibid). Although this issue is therefore not exclusive to local income tax, it will be need to be taken into account when considering how to design the equalisation process, which could be used to combat some of these variations in the distribution of the tax base.
- 6.16 It will be crucial to fully understand the likely levels of fiscal flight; even if previous research is correct and such behaviour is usually limited to high earners, even a very small rate of fiscal flight could have significant impacts on revenues as a high proportion of tax receipts come from a small proportion of the highest income earners in Wales. Research by the Institute for Fiscal Studies highlighted that if twenty of Scotland’s highest earners moved their main residence out of Scotland this could equate to a revenue loss of £20 million (Scottish Parliament, 2015, p. 8). In Wales, the top ten per cent of earners contribute more than the combined income tax revenue of the lowest-earning seventy per cent (Ifan and Poole, 2018,

p. 7), meaning Wales cannot risk incentivising migration of even a small number of higher earners.

- 6.17 One interview participant suggested that the risk of fiscal flight for high earners could be mitigated by setting a fixed rate across Wales for those above a certain income threshold, with a variable rate for lower earners. This would counter movement between local authorities, but could be less effective in persuading high earners to remain in Wales.
- 6.18 This factor may benefit from further research on public perceptions. When asked to what extent a tax rate would influence their decision to live in Scotland, 38 per cent of respondents to the Scottish Government research stated that this would influence them a lot. Among this group, respondents aged 45-54 were most common (62 per cent), along with single people (21 per cent) who may be more mobile. Those who stated that it would not influence them at all were in the minority (43 per cent) (Scottish Government, 2008, p. 44-45).

Disincentives to work or save

- 6.19 A local income tax which is linked to ability to pay has the potential to incentivise people to reduce their income; put simply, taxpayers will appreciate that the more they earn, the more they are expected to pay, and may take steps to reduce this income in response.
- 6.20 The extent of any behavioural changes of this kind will depend heavily on what indicators are used for ability to pay. If the system focused solely or mainly on income from employment or self-employment, this is likely to push the burden of taxation more heavily onto the working age population, and away from those in education or retirement. This could result in resistance, and could be interpreted as a disincentive to work (Local Government Finance Review Committee, 2006, p. 108; Gibb and Christie, 2015, p. 14). This will also be influenced by public attitudes to the taxation of earned versus unearned income discussed in Section 4. Furthermore, as the size of the working age population reduces in Wales, this effect could be more pronounced (Local Government Finance Review Committee, 2006, p. 114). Between 2000-2017 the rate of population growth for the elderly in Wales was approximately 1.4 per cent, compared to a rate of population growth of those aged 16-64 of approximately 0.4 per cent (OECD 2020b, p. 73). If a large proportion of older people see a decrease in their local tax liability through local

income tax, this could be a factor in decisions about retirement age (Marsh, 2017, p. 50). The impact on incentives to work was one of the key downsides to a local income tax identified by the 2006 Burt Review in Scotland (Welsh Government, 2016, p. 44; Lyons, 2007, p. 262).

6.21 Incentives and disincentives to work are usually most acute for households on certain thresholds; for parents this may be decisions about whether the benefit of hours worked is greater than the cost of childcare services. Equally, for those on out-of-work benefits, taxes may factor into their assessment of whether it is worth returning to work. All of these eventualities should be considered in the context of economic conditions and labour market opportunities which will dictate whether adjusting hours or going back to employment are actually possible (Commission on Local Tax Reform, 2015, p. 38).

6.22 During interviews some opposing views emerged about the potential scale of this kind of behavioural response. One participant highlighted that this issue may not be unique to a local income tax, as it is already present to some extent under the council tax system:

‘We already have, to some extent, a local income tax in reality for those in receipt of CTRS; the more they earn, the more they will be expected to pay, and therefore we already have some of the incentive effects in relation to whether to work more hours, it’s just they are only concentrated on the lowest earners, rather than on everyone.’

6.23 By contrast, another participant saw disincentives to work as a potentially significant issue for an income-based local tax:

‘Switching to taxing labour depresses the incentive to work across the country, whether that’s working less hours or working at all. There’s a general deflationary impact on willingness to work. That would depress economic output. There would be a more general impact because we can all make decisions at the margin about how much we work, and if everyone works one per cent less, that has a huge impact on economic output and productivity.’

6.24 If other forms of wealth such as savings or the interest they generate were included as an indicator of ability to pay, this could discourage saving. This will undoubtedly have a long-term impact on financial resilience to shocks such as

redundancy or periods of ill health, and is inconsistent with current advice in the debt advice sector, where even those with significant debts are encouraged to put away a small regular amount in savings. This was highlighted as a potential issue by one stakeholder:

‘You’re encouraged to be saving and making plans for a rainy day, not to be relying on the state for things, but you would be penalised. This has been a problem for years with welfare benefits, where people feel they have been told to save but are then penalised for having savings. You’d have to set the savings threshold a lot higher than it currently is, otherwise there’s no incentive to save.’

- 6.25 As with all tax systems, there is also a more general risk that taxpayers will seek options to get around tax liability or arrange their finances in a way which minimises their exposure to local taxation. This was raised by a number of respondents to the Scottish Government consultation on local income tax, with concerns relating to, for example, receiving salary as dividends rather than cash, or investing in property to avoid cash savings being targeted (2008, p. 24). This type of behavioural change will depend on what indicators are used to assess ability to pay. It is also fair to say that behavioural changes of this kind are likely to be limited to populations who have ready access to skilled tax planning and financial advice (Scottish Parliament, 2015, p. 5). As well as modelling the potential revenue from a local income tax, some awareness of the effect of behavioural changes will be needed; this is referred to as the post-behavioural tax yield (Marsh, 2017, p. 48).
- 6.26 As well as new behavioural changes that local income tax may introduce, the removal of council tax would also mean the loss of some positive behavioural changes, such as the council tax premium on second properties that can be applied in Wales to encourage increased use of property (Commission on Local Tax Reform, 2015, p. 38). One interviewee felt that second properties could become a significant issue for Wales, stressing that care should be taken in deciding how they are treated for local taxation purposes.
- 6.27 Behavioural changes could be very subtle and difficult to record; for example, if one individual decides to increase his monthly pension contributions (Marsh, 2017, p. 48), or even take advantage of a cycle to work scheme deducted at source from

salary, their net income will be reduced. The cumulative effect of such small changes could be significant (Scottish Parliament, 2015, p. 3).

- 6.28 It must be acknowledged that not all behavioural changes can be predicted; a new tax system has the potential to provoke unexpected avoidance behaviour (Prabhakar, 2012, p. 78). This was highlighted in interviews:

‘Any intervention will have a variety of effects on behaviour. The things that do come out may be quite surprising, you just don’t really know how people will react. There may be behavioural changes that only make sense in hindsight.’

- 6.29 It is also quite challenging to accurately measure behavioural responses because it is difficult to separate the effect of the tax from other factors which may have influenced the behaviour (Marsh, 2017). Kopczyk (2005) argues that most of the economic modelling conducted on behavioural changes fails to isolate tax changes from other factors (Marsh, 2017, p. 53). It should also be noted that behavioural changes in devolved nations such as Wales may be partially attributed to other changes in UK Government tax policy (Scottish Parliament, 2015, p. 3) because of the interaction between different taxes.

- 6.30 Behavioural responses need to be viewed in the round, and understood as multidimensional; people rarely make significant decisions such as moving to another nation for one sole reason. This was highlighted by a number of interview participants:

‘There are other questions that go into decisions about where you live, for example school catchment areas would be much more important for some people than small variations in their tax bill.’

- 6.31 Any attempts to measure responses to a local income tax post-implementation would need to have a long-term focus, as short-run and long-run effects can be very different, and responses may unfold over many years (Cassidy et al, 2015, p. 3).

- 6.32 One potential option to mitigate behavioural changes is to invest in public awareness and understanding of the new tax system, in particular the ways in which revenue from local taxation is spent on local services. Those taxpayers who can understand and see the impact of their contributions in their local area may be

less likely to move (Scottish Parliament, 2015, p. 3). The visibility of the tax system will also be a factor in behavioural change; taxpayers who are not aware of changes in the tax system will not be motivated to respond.

- 6.33 Behavioural change should also be factored into decisions about the transition period to a local income tax, as some individuals may engage in forestalling, where they immediately change their behaviour to avoid increased taxation from an upcoming reform (Marsh, 2017, p. 50).

Key points:

- The size of the border and concentration of taxpayers in border local authorities increases the potential scope for fiscal flight from Wales to England for those for which a local income tax would be more expensive than council tax.
- Particular care should be taken when designing the system for students to protect the future workforce and tax base.
- Fiscal flight is likely to be concentrated on high earners with the means to move, but even losing a small number of high earners would have a significant impact on the tax base.
- If local authorities have discretion to set their own rates, fiscal flight at a local level could manipulate the tax distribution across Wales, creating a risk of a 'race to the bottom' to attract higher earners to local areas.
- The extent to which taxpayers are incentivised to work or make savings will depend heavily on the way in which ability to pay is defined. This will also dictate how many opportunities taxpayers have to manipulate their finances to reduce their exposure to local tax.
- Interview participants disagreed about how many people may be influenced in their decisions about work, and whether problems of this kind are already present under council tax. If a tax based on income did have a general deflationary impact on willingness to work, this could significantly reduce the tax base.
- Not all behavioural changes can be predicted, and subtle changes may be challenging to measure.

Further research:

- Conduct research with the public to understand what factors inform decisions about relocating. This could improve understanding of the true risk of fiscal flight to other countries, or between local authority areas, in response to tax reform.

Public understanding and perception of fairness

6.34 Another important consideration will be the way in which citizens of Wales perceive a local income tax. Although the technical issues of optimising the tax rate and revenue levels are crucial, any new tax system will only succeed with public support (Prabhakar, 2012, p. 78). All interview participants stressed the importance of thinking about public approval from the outset, not just after implementation. For example:

‘You’d have to have a very strong communication strategy, which isn’t just seen as an add-on, it’s fundamental and essential. Without it, there could be a lot of resistance.’

6.35 A carefully designed communication strategy would need to inform the public about the rationale for reform, the practical workings of the system, and perhaps most importantly, how it may affect the amount they are asked to contribute. The link between the level of understanding of a tax system and the level of acceptance it benefits from is well established in research (McCluskey, 1998, p. 52; Commission on Local Tax Reform, 2015, p. 57). For example, evidence from Sweden suggests that those who are best-informed about the tax system are less likely to want to decrease tax rates (Jakobsson, 2013, pp. 171-172). Therefore, a complicated tax which is inaccessible and difficult to navigate is unlikely to be seen as fair, and may encourage resistance.

6.36 Horizontal equity may be the most common way in which citizens assess the fairness of local taxation (McCluskey, 1998, 53). They may ask, how much does my family member, my neighbour or my colleague pay in local taxation, in comparison with me? This is a key justification for economic modelling of the realities of the tax, to predict which taxpayers may feel that they have lost out as a result of the reform. If this information is available during the design stage, there

will be time to develop solutions to mitigate the impact of changes in the tax payable for those most affected.

- 6.37 The relationship between the amount people pay and their perception of the quality of services in their area will be important in overall public perceptions (Prabhakar, 2012, p. 78-79). Those taxpayers who are frustrated by local services may be more negative about the tax system, whereas those who feel they can see the value of their contribution in the local area may be more supportive. However, the Scottish Government's survey found that 59 per cent of respondents would not be inclined to pay more for local services to provide for better quality local services (2008, p. 15), suggesting that the level of the bill could be the most important factor for most people.
- 6.38 Research in the US has indicated that moral arguments regarding taxation often have strong influence over public attitudes (Graetz and Shapiro, 2005, cited in Prabhakar, 2012, p. 80). This could be beneficial for a local income tax if a clear message can be communicated, supported by evidence, that a local income tax would be more progressive and fairer than the current council tax system. Prabhakar states that 'embedding debates within a wider moral framework is one way in which policy-makers might try to build public support for a tax system' (2012, p.87). This kind of appeal to the moral views of taxpayers should also take into account their concerns about opportunities for others to avoid paying a tax, in part because this may increase the amount they are expected to pay in the long-run (Prabhakar, 2012, p. 84).
- 6.39 Ongoing research on public understanding of taxes in Wales found that, in June 2019, 40 per cent of respondents to the Wales Omnibus Survey were aware of the Welsh Government's ability to set different income tax rates in Wales (Welsh Government 2020a, p. 3). The level of knowledge about WRIT is increasing year on year, with 39 per cent stating that they had become aware through watching TV and 34 per cent through a letter from HMRC (Welsh Government 2020a, pp. 3-4). Lessons could be learnt from the communications used for the Welsh Rate of Income Tax (WRIT).
- 6.40 Age influences attitudes to taxation, as evidenced by Prabhakar in his focus group research (2012) which found that inheritance taxes are most unpopular among older people, whereas fuel duties are perceived negatively by younger

respondents (p. 77). The way in which ability to pay is defined is likely to have significant implications for how local taxation is paid over the life cycle in Wales, which could be important for the level of support it generates in different age demographics.

- 6.41 One way to try to predict any issues of public approval would be to survey the taxpayers of Wales. The Scottish Government's 2008 survey produced signs of support for a local income tax, with 55 per cent of respondents labelling it as the fairest approach to local taxation (p. 63). To be most useful, a survey of this kind would need to reflect reliable modelling of the realities of a local income tax so that participants could make an informed judgement on the exact scheme proposed, rather than on local income taxes in general.
- 6.42 Looking more broadly, attitudes to a local income tax should be assessed in the round, including the interrelation they may have with the wider tax system (Prabhakar, 2012, p. 78). Where citizens consider one tax as part of the wider tax system they often speak of "trade-offs" between each tax. One interviewee described the total tax system in Wales as being like a pie, with local taxation forming one slice which needs to fit into the wider whole.
- 6.43 On a practical level, if a local income tax is to be assessed and collected by local authorities, care will need to be taken to limit the number of touchpoints for the taxpayer. This could be easier for a purely local system in comparison with a tax collected at source, as all queries that taxpayers may have would be directed to the local authority, rather than any additional external agencies (Mikesell, 2003, pp. 4-5). An effective system of appeals will also be needed so that tax payers feel they have an opportunity to challenge their bill if they feel it is unfair or inaccurate.
- 6.44 If taxpayers are expected to provide detailed information on their financial circumstances, the level of administrative burden this creates may influence support for the system. It may be perceived as intrusive depending on the level and detail of the information requested. The proximity of local authority staff to each taxpayer is much greater for a locally administered system in comparison with a nationally collected one, creating a risk that taxpayers may be asked to provide detailed financial information to a member of staff that they know personally (Chartered Institute of Public Finance and Accountancy, 2004, pp. 30-31). This would require careful consideration of data protection procedures.

However, confidence in the ability of local authorities to take on such issues of data security was expressed during interviews:

‘Local authorities are used to dealing with incredibly confidential and sensitive data. As long as there is understanding, training and development and these things are built into inductions of new staff, I can’t see there being any major issues.’

6.45 Data protection issues therefore may not present a new barrier compared with council tax, but there would be an undeniable need to increase the *capacity* of such systems to protect the data of *all* taxpayers.

Key points:

- Public approval and public understanding of local taxation are interconnected, meaning communication strategies for a local income tax must be considered at an early stage of the design.
- The quality of local services influences public attitudes, but only to an extent. The level of the bill is often most important.
- Interviewees suggested that putting the rationale of the reform into a moral context may increase public support, as long as it is supported by evidence.
- The practical interactions that taxpayers have with the local authority as tax administrator are important, and protection of personal data will play a big part in fostering trust and support.

Further research:

- Model the economic realities of a local income tax. The primary aim of modelling should be to predict the revenue raising potential of a local income tax. Modelling should also increase understanding of how the burden of local taxation may change for different demographics, and any equality implications.

7. Conclusions and further evidence needs

7.1 Throughout this report key findings have been summarised after discussion of each topic. This section reiterates these findings, but because of the multifaceted and interlinked nature of tax design, these statements should be read in the context of the detailed analysis in the body of the report. The findings are organised by topic.

International uses of local income tax

- Eighteen out of 37 OECD countries use some form of local income tax.
- Evidence suggests that in all of these countries the tax is collected at source through the equivalents of pay-as-you-earn and HMRC.
- Local income tax makes up a small proportion of local revenues (less than 20 per cent in some countries, such as the US, Spain and Korea), whereas it represents more than 90 per cent of local revenues in Finland and Sweden.
- At least six of the eighteen countries identified require universal self-assessment tax returns for all taxpayers.
- Local discretion over tax rates is common, but varies in terms of the range of tax rates.
- There are some useful lessons to be learnt about equalisation from Denmark and Sweden.
- There are no current international examples of a local income tax which is assessed and collected at the local level, as is being considered for Wales.

Design of a local income tax

Designing indicators of ability to pay

- The design of a local income tax requires careful consideration of what should be indicators of ability to pay. These indicators need to be reliable and accurate.
- There are many types of income and wealth which could influence someone's ability to pay, and deciding which to include may be the most challenging aspect of designing a local income tax.
- Income from employment will be the major indicator of ability to pay, but variable working makes this more complicated to assess.

- Self-employed income should be treated the same as income from employment, but the different chronology of taxation of self-employed income presents challenges.
- Savings and investments could be considered a factor in ability to pay.
- The inclusion of income from Universal Credit or other benefits prompts consideration of a minimum income threshold for local income tax.
- Taxation of pensioners may be crucial in the perception of local income tax, given criticisms of council tax being unfair for those with reduced income later in life, though the extent of this requires further analysis. If pension income was not included in the scope of an assessment of ability to pay, this will inevitably shift the burden of taxation onto the working-age population.
- The literature and interviewees put forward many reasons for bills to remain at the household level, rather than switching to an individual basis, but this is at odds with the international approach.
- Ability to pay could be based on more than income alone, but it may be difficult to accommodate all potential circumstances. Some interviewees felt that it was not the role of a tax to be sensitive to household circumstances.
- A key benefit of a local income tax may be the ability to design in from the outset things which are normally dealt with through discounts and exemptions, such as student status. This relates to the idea of a minimum income level, which would cause many who currently receive discounts and exemptions to naturally fall out of the system.

How to assess ability to pay

- Interview discussion focused on two main options: data sharing between agencies such as HMRC or DWP and local authorities, or purely local assessment and collection.
- Data sharing was seen as an obvious initial option, but one which would present challenges. It is difficult to reach agreement for such arrangements and to make them reciprocal.
- In terms of purely local assessment and collection, positive views were expressed about the existing abilities of local authorities to assess finances, but there were reservations over the potential increase in the scale of the work

and the different types of income which would need to be assessed to get a full picture.

- What time period to assess income over will be important as this will influence the chronology of collections and the predictability of revenue.
- If income is self-reported this introduces a risk of inaccurate reporting and will require some form of auditing process.
- There is a need to be realistic about how large a change a local income tax would be in terms of requiring reporting of income, given that most people in Wales currently have very little interaction with the tax system. Reporting could be perceived as burdensome or intrusive, so care would need to be taken in the messaging which accompanied this kind of change.
- Existing tools such as the Standard Financial Statement are used to assess household finance, but interviewees doubted that it is universally applicable and questioned the assumptions it makes about living costs which may be inconsistent with the wider social security system.
- Overall, local assessment and collection may only be viable if the costs do not outweigh the benefits in terms of revenue yield and overall fairness to taxpayers.

Local discretion

- The theoretical literature supports local authorities having discretion for their own tax rate to promote responsibility and encourage them to improve the prospects of their residents. Many interview participants also saw this as a key potential benefit of local income tax, both practically and symbolically.
- Some suggested that variation should be limited to a small band to avoid large inequalities, and highlighted that the actual rates may converge over time to a point where there is little actual variation across Wales.
- Local discretion over rates was not popular with the public when the Scottish Government conducted a consultation on local income tax in 2008.
- Equalisation will need to be carefully designed so as not to remove the incentive effects for local authorities to develop their revenue potential.

Implementation of a local income tax

Budgeting

- A key decision for local income tax will be whether to redesign the timelines associated with local taxation to align with the availability of information, or try to fit it into the current system.
- Different forms of income will be paid and assessed at different intervals, introducing delay into the assessment system depending on how ability to pay is defined.
- A holding tax could incentivise taxpayers to provide their financial information, whilst ensuring a predictable yield from those who choose not to opt in to the new system. The rate of a holding tax would be challenging to calculate.

Policy development and piloting

- Pilot projects would allow different versions of a local income tax to be trialled to understand how they work in practice, but pilots can introduce unfairness which could be unpopular or open to legal challenge.
- A local income tax which involves the public in all three stages of design, implementation and evaluation may encourage greater support as opposed to a new system which is imposed in a “top-down” style.

Transitional Arrangements

- The transition from council tax to local income tax needs to be carefully planned, with consideration given to reliefs and other schemes to ease the impact of sharp increases in bills.
- Local authorities could defer the implementation of the scheme to give taxpayers plenty of notice of the changes.
- They could consider payment deferral schemes for those without the funds to make payments as normal.
- Transitional reliefs over a defined period have been used successfully in Wales and Northern Ireland, but come with significant costs.
- The timescale of reform is uncertain, but could be considerable, with previous estimates being longer than a single Senedd term. This may depend on the extent of legislative change required and the ability to achieve political consensus.

- Transition schemes introduce large expenses, but this is not unique to a local income tax and would be a factor in all major tax reform.

Impact of local income tax

Behavioural changes

- The size of the border and concentration of taxpayers in border local authorities increases the potential scope for fiscal flight from Wales to England for those for which a local income tax would be more expensive than council tax.
- Particular care should be taken when designing the system for students to protect the future workforce and tax base.
- Fiscal flight is likely to be concentrated on high earners with the means to move, but even losing a small number of high earners would have a significant impact on the tax base.
- If local authorities have discretion to set their own rates, fiscal flight at a local level could manipulate the tax distribution across Wales, creating a risk of a 'race to the bottom' to attract higher earners to local areas.
- The extent to which taxpayers are incentivised to work or make savings will depend heavily on the way in which ability to pay is defined. This will also dictate how many opportunities taxpayers have to manipulate their finances to reduce their exposure to local tax.
- Interview participants disagreed about how many people may be influenced in their decisions about work, and whether problems of this kind are already present under council tax. If a tax based on income did have a general deflationary impact on willingness to work, this could significantly reduce the tax base.
- Not all behavioural changes can be predicted, and subtle changes may be challenging to measure.

Public understanding and perception of fairness

- Public approval and understanding of local taxation are interconnected, meaning communication strategies for a local income tax must be considered at an early stage of the design.

- The quality of local services influences public attitudes, but only to an extent. Previous public consultations suggest that the level of the bill is often most important.
- Interviewees suggested that putting the rationale of the reform into a moral context may increase public support, as long as it is supported by evidence.
- The practical interactions that taxpayers have with the local authority as tax administrator are important, and protection of personal data will play a big part in fostering trust and support.

7.2 These findings illustrate that a locally administered income tax for Wales would be a unique system when considering international examples of local taxation. It presents a number of challenges, the most significant of which is likely to be how to define ability to pay. Many aspects of the implementation of a local income tax would require significant expansion of current provision and existing skills in local authorities, so it is key that they are involved in the design process. One key benefit of a local income tax may be the ability to design in from the outset an assessment of ability to pay, something which is achieved to some extent through the current reactive discounts, exemptions and reduction schemes, but only for the lowest earners.

7.3 This research has also highlighted where gaps in the evidence base remain if such a reform is to be delivered. To support further exploration of the feasibility of a local income tax in Wales and its possible design, the Welsh Government should consider conducting the following research:

- (1) Model the economic realities of a local income tax. The primary aim of modelling should be to predict the revenue raising potential of a local income tax. Modelling should also increase understanding of how the burden of local taxation may change for different demographics, and any equality implications.
- (2) Investigate the extent to which citizens of pension age struggle to pay council tax, using these findings to inform the definition of ability to pay for local income tax and to decide whether alternative provision would be required for this demographic.
- (3) Investigate in greater detail the feasibility of data sharing in relation to assessing ability to pay, involving key stakeholders.

- (4) Investigate further the kinds of employment which contribute most to the tax base in Wales, to understand the level of potential volatility during economic downturns.
- (5) Consult local authorities to understand their views on the feasibility of local income tax, but only once a clear set of options for its administration have been developed. The focus of this consultation should be the practical challenges which would need to be overcome for local authorities to successfully transition to and administer a local income tax.
- (6) Consult the public on the rate of local income tax and whether local authorities should have the discretion to vary their rate. This consultation should be part of a wider communication strategy which clearly explains the rationale behind the reform.
- (7) Conduct research with the public to understand what factors inform decisions about relocating. This could improve understanding of the true risk of fiscal flight to other countries, or between local authority areas, in response to tax reform.

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9. Appendices

Annex 1 – Overview of Current Council Tax System

Council tax replaced the highly controversial Community Charge in England and Wales, a short-lived system introduced by the UK Government in 1990 prior to the devolution of local government finance matters to Wales in 1998. It is useful to briefly reflect on the development of the Community Charge and its predecessor, Domestic Rates, when seeking to learn lessons in designing a fairer system of local taxation. The Community Charge was billed at a flat rate to every adult who had sole or main residence in the local authority area, the rate being set by each local authority. It represented a significant departure in design from the previous system of Domestic Rates which was based on nominal rental values of property, assessed periodically.

Criticisms of outdated and cancelled valuation cycles were an impetus to move from Domestic Rates to the Community Charge. However, the departure from a property based tax to one levied at a fixed rate per adult produced controversial reactions; for example, the public were very critical of the fact that, under the Community Charge system, ‘dukes and dustmen’ would be liable for the same amount (Higham, 2016), demonstrating the public expectation that a fair local tax should include some consideration of personal means.

Introduced by the Local Government Finance Act 1992, council tax came into use in the 1993-94 tax year. It is a hybrid form of taxation, combining a property tax and a personal tax for the provision of local services. Council tax is billed as an annual charge, following the standard financial year of April to March. Although it can be paid in a lump sum, it is most commonly paid in ten or twelve monthly instalments, typically by direct debit. It is the responsibility of the taxpayer to set up a direct debit or manually pay their monthly bill by bank transfer. If the tax is not paid, the options available to local authorities to enforce payment are set out in regulations.¹²

To calculate the liability of each household, a chargeable property is allocated a band which relates to the estimated value of the property. This estimated value is based on a number of standardised assumptions about the property, which may or not be accurate, but ensure a consistent approach across the large number of properties in Wales. For example, all properties are assumed to have vacant possession and to be in a reasonable

¹² The Council Tax (Administration and Enforcement) Regulations 1992

state of repair. Other factors which may typically influence the value of a property are not included in the valuation for the purposes of council tax, such as development potential or the value of internal fixtures¹³. Bands are decided by the Valuation Office Agency and can be appealed. Issues can arise when allocating new properties to a council tax band, as this is based on an estimate of what the property would have been worth in 2003, the last time a formal revaluation of all properties was conducted in Wales. The current system has therefore allowed significant gaps to develop between actual market price and the estimated value for the purposes of council tax banding, which was explored in recent research by the Institute for Fiscal Studies ([Adam et al, 2020](#)).

In Wales, following the revaluation exercise carried out in 2005, there are nine bands labelled A-I based on property valuations from 2003 (ibid, p. 7). Wales was unique in its decision to conduct a revaluation, with bands in England and Scotland still being based on 1991 values (ibid)¹⁴. Band I was introduced for properties which have an estimated value of £424,000 or over, therefore applying to the most valuable properties in Wales. In the current tax year, approximately 0.4 per cent of properties in Wales fall into the highest band I. Band C is the most common band in Wales (21.8 per cent), which includes all properties notionally valued between £65,001 and £91,000.

The charges in each of the bands are calculated based on the property value as proportionate to a Band D property. For each financial year, local authorities will calculate the income they require to fund local services and set a tax rate based on the annual levy on a Band D property. The rest of the bands will change if the Band D rate is altered, but only ever in a fixed proportion to the Band D rate.

In the current tax year (2020-21) there are 1,388,582 taxable properties in Wales (Statistics for Wales, 2020d). The largest local authority areas in terms of numbers of chargeable properties are Cardiff (146,974), Swansea (106,472) and Rhondda Cynon Taf (105,356). Merthyr Tydfil is the smallest local authority, with 26,593 chargeable properties (ibid).

In terms of the collection rate of council tax, the most recent mean average for Wales was 97 per cent (2019-20) (Statistics for Wales, 2020b, p. 1). Across Wales, collection rates range between 93.9 per cent in Blaenau Gwent and 98 per cent in Neath Port Talbot.

¹³ The full list of assumptions can be found in [The Council Tax \(Situation and Valuation of Dwellings\) Regulations 1992](#).

¹⁴ Northern Ireland use domestic rates.

The link between council tax and ability to pay

As set out in Annex 1, council tax is a hybrid property and personal tax whereby the amount payable is linked to the estimated value of an individual's property, with elements of the design accounting for personal circumstances. McCluskey et al (1998) argue that, despite the historical use of property value as a measure of ability to pay, in modern times its usefulness or accuracy as a predictor of household income or financial circumstances is doubtful (Davies and Orton, 2007). This creates a risk of disconnect between the amount billed and the taxpayer's ability to pay.

A commonly accepted indicator of the fairness of a tax system is whether it is progressive, though progressiveness can be measured either in relation to incomes or in relation to property values. In a progressive tax system, the lower the 'value' of the entity being taxed (however defined), the lower the tax rate. The current National Income Tax is a progressive system of taxation in relation to income; as a person's income increases they will pay an increasing share in income tax. By contrast, in a regressive system the opposite relationship can be found; the lower the value of the entity being taxed, the higher the tax rate.

While the tax rates set for the nine bands A-I do increase as we move up the bands, when commentators refer to council tax as being regressive what they mean is that the more each chargeable property is worth, the smaller the bill is as a proportion of its value.

To illustrate this, the difference in Wales between a Band A property (valued at £44,000 or below) and a Band I property (valued at £424,000 or above) is at least 9.5-fold. However, the difference in the tax bills issued to households in these two bands is 3.5-fold (Adam et al, 2020). This is an example of regressivity which was built into the system from the start (Commission on Local Tax Reform, 2015).

Council tax could also be considered regressive in relation to the proportion of a household's income which is used to pay it, though this is difficult to measure in a broad sense.

Davies and Orton (2007) sought to empirically test the relationship between property values and income levels, concluding that although there was a strong positive relationship between property values and income with respect to higher income households, the relationship for lower income households was 'U-shaped'. If council tax was truly progressive to income, its expression would be linear. This is not to say that house price is of no use in predicting the income of the householder, but that the relationship is stronger

for higher income households than for lower income households (Davies et al, 2007, p. 771).

Where local taxation is regressive to affordability, there is particular pressure on households which may be 'asset rich, but cash poor' (Bennett et al, 2016). The fact that someone is resident in a house of a particular value does not necessarily tell us anything about their cash flow, which will be influenced both by their sources of income and the cost of their circumstances (Johansson-Linden and Gayer, 2012 in Bennett et al, 2016). For example, pensioners are more likely to own their properties, which may be of higher value, but will most likely receive a reduced income from their pension than when they were working. Equally, someone of working age may live in a high value property, but may be paying a significant mortgage or premium rent, leaving them with little money for household bills such as council tax.

Even if council tax could be reformed to make it progressive to property values, there is no guarantee that it would also be progressive to household incomes. High value properties can be occupied by low-income households, as much as low value properties can be occupied by high-income households. In addition to relative incomes, outgoings can vary significantly between two households of similar incomes levels. It must be acknowledged that the factors which influence choice of property are highly complex and diverse (Lyons Inquiry, 2007, p. 231) and that property value is therefore not always a good indicator of its inhabitants' ability to pay priority bills.

The hybrid design of council tax helps to mitigate some of the impact on households through the range of discounts, exemptions, disregards and reductions which are applied to the bill if the taxpayer or property is deemed eligible. Some of these are directly linked to personal means, others exist to ensure the tax is collectable and efficient. However in general, it could be argued that some of these measures would not be necessary if the tax design were based more closely on ability to pay. The current system relies on retrospective targeting of groups who, because of their circumstances, may be unable to pay their full council tax liability (Alvanides, 2004).

In the current tax year (2020-21) there are 60,650 properties in Wales which are exempt from paying council tax (Statistics for Wales 2020c). There are twenty four forms of exemption, the current most common exemption being empty and unfurnished properties, of which there are 17,438 across Wales (ibid). 16,802 properties are exempt because they

are occupied solely by students (ibid). Since 2019, a new exemption has applied to care leavers under the age of twenty-five years.

There are also a considerable number of different discounts available which are linked to household circumstances, such as single adult discount. Current records indicate that 588,46015 of the 1,388,582 chargeable properties in Wales receive some form of discount or exemption (Statistics for Wales 2020c; Statistics for Wales 2020d). This equates to approximately 39 per cent of all chargeable properties. Therefore, a large proportion of households in Wales will not pay all or any of the council tax bill which is calculated with reference to their property banding, for a wide range of different reasons.

A further example of the reductions available is the Council Tax Reduction Scheme (CTRS). The CTRS was introduced in Wales following the abolition of Council Tax Benefit by the UK Government in 2013. It provides low income households with a partial or complete reduction in council tax liability. To assess eligibility, local authorities consider weekly income and any capital, such as savings and property.

The CTRS is a key mechanism in the current system for reducing council tax bills for those on the lowest incomes. 275,042 households in Wales currently receive a Council Tax Reduction, of which 110,744 are pensioner households and 165,643 are of working-age (Welsh Government 2020e, p. 3). 216,803 households who qualify for a Council Tax Reduction currently pay no council tax at all (ibid). However, it is estimated that between 55 and 65 per cent of those who are eligible for the reduction have taken it up (ONS Family Resources Survey, in Welsh Government 2018, p. 4), meaning many others may be paying more than they need to.

It could be argued that the CTRS provides assistance for individuals on very low incomes, but does not assist those on modest incomes or highly variable incomes (Commission on Local Tax Reform, 2015). Research on the Scottish system highlighted that support provided by the CTRS is greater for pensioner households than for those in work, with the system remaining regressive to income for households with income above the lowest 20 per cent (Commission on Local Tax Reform, 2015). This means that, although CTRS may be effective for those on the very lowest incomes, it does not fully resolve the problem that

¹⁵ This was calculated by combining 'Total all exemptions' from StatsWales ['Dwellings exempt from council tax, by class \(number of dwellings\)'](#), with 'B1 – Dwellings with no discounts' from StatsWales ['Council Tax dwellings, by CT1 row description \(number of dwellings\)'](#).

those in the top bands still pay a smaller proportion of their income than those in lower bands who are not eligible for CTRS.

In summary, depending on how it is analysed, council tax can be considered regressive in relation to property value and potentially household income, the latter being partially remedied by the large range and volume of discounts, disregards, reductions and exemptions available in Wales on a reactive basis. The CTRS shields many low income households from liability for local tax, but not all who could be eligible, and it does not fully resolve the issue of regressivity to income.

Annex 2 – Literature Sources, Key Words and Filters

Source	Search Strategies
<u>Databases</u>	
ECONLIT	<p><u>Keywords</u> <u>Filters:</u> Peer Reviewed / English language</p> <p>1 (“local income tax(es)” OR “municipal income tax(es)” OR “state income tax(es)” OR “state income tax(es)” OR “provincial income tax(es)”) AND (model* OR system*) AND (evaluat* OR review* OR analysis OR evidence OR research OR impact)</p> <p>2. “Solidarity Surcharge”</p> <p>3. (“local government” OR “sub-central government” OR “sub-national government” OR city OR county) AND “income tax(es)” AND (model* OR system*) AND (evaluat* OR review* OR analysis OR evidence OR research OR impact)</p>
Web of Science	<u>Keywords:</u> As above
Ingenta	<u>Keywords:</u> As above
Science Direct	<u>Keywords:</u> As above
OECD	<p><u>Keywords</u> (ab/ti)</p> <p>1. “local income tax(es)” OR “municipal income tax(es)”</p> <p>2. (“local government(s)” OR “sub-central government(s)” OR “sub-national government(s)”) AND “income tax”</p> <p><u>Browsed:</u> Taxation Working Papers <u>Browsed Country reports:</u> Belgium; Canada; Denmark; Finland; Italy; Korea; Norway Portugal; Sweden; United States; Spain; Switzerland; Germany</p> <p><u>Filters:</u> Taxation Publications; English Language</p>
<u>Websites</u>	
Institute for Fiscal Studies	<p><u>Keywords</u></p> <p>1. “local income tax(es)” OR “municipal income tax(es)” OR “state income tax(es)” OR “provincial income tax(es)”</p> <p>2. (city OR county) AND “income tax(es)”</p> <p>3. (“local government(s)” OR “sub-central government(s)” OR “sub-national government(s)”) AND “income tax”</p> <p>4. “solidarity surcharge”</p> <p>5. “local taxation”</p>

Wales Centre for Public Policy	<u>Keywords:</u> As above
Welsh Government	<u>Keywords:</u> As above
National Assembly for Wales	<u>Keywords:</u> As above
Welsh Government Library Catalogue	<u>Keywords:</u> As above
Scottish Parliament Information Centre	<u>Keywords:</u> As above
Scottish Government	<u>Keywords:</u> As above
House of Commons Library	<u>Keywords:</u> As above
.gov.uk (research papers)	<u>Keywords:</u> As above
RAND	<u>Keywords:</u> As above
Institute for Public Policy Research	<u>Keywords:</u> As above
International Monetary Fund	<u>Keywords:</u> As above
Joseph Rowntree Foundation	<u>Keywords:</u> As above
LSE Research	<u>Keywords:</u> As above
Chartered Institute of Public Finance & Accountancy	<u>Keywords:</u> As above
NBER	<u>Keywords:</u> As above <u>Filters:</u> Working Papers / Books Past 10 years
IDEAS Bibliographic Database	<u>Keywords:</u> As above
Tax Foundation	<u>Keywords:</u> As above
Analysis & Policy Observatory	<u>Keywords:</u> As above
Tax Admin Research Database	Browsed publications

Annex 3 – Topic Guide

Interview Schedule – Feasibility of a Local Income Tax

- Introduce researchers, overview of our roles
- Objectives and nature of the research
- Overview of how this project fits into wider considerations of reforming the council tax system
- Reiterating terms of their participation, making sure they have read privacy notices
- Asking if they have any questions about the research or interview
- Asking participant to give an overview of the experience they have of relevance to the design of a Local Income Tax.
- Reassure that if there are any questions they don't feel able to answer, or answer in any detail, that this is fine (questions to be refined for each individual candidate in advance).

1. Aims of a New Local Tax

- A. If council tax were to be reformed, what do you feel should be the most important goals of a new system of local taxation?

E.g. affordability, stability, predictability, buoyancy, complexity v simplicity, rates of compliance.

2. General Understanding of a Local Income Tax

- A. What is your understanding of Local Income Tax?
- B. What do you see as the main advantages and disadvantages of a Local Income Tax?
- C. Are you aware of anywhere a Local Income Tax has been implemented well/poorly?
- D. Where it has been implemented, do you know how Local Income Tax is typically administered/collected?

The following questions relate to key factors in the design of a Local Income Tax for Wales:

3. Liability

- A. One common form of Local Income Tax which is used in other countries is collection at source through PAYE, as an additional tax to the National Income Tax. Given that this is not currently possible within the legal powers of the Welsh Government, what are your views on alternative options to collect a Local Income Tax?

If responses are limited, ask for their views on PAYE approach.

- B. What are the options for data sharing between HMRC/DWP and local authorities, for the purposes of calculating Local Income Tax liability?
- C. If data sharing was not possible, how could local authorities themselves assess household affordability to calculate Local Income Tax liability?

D. How would different options affect forecasting of revenues?

E. What would we need to know to deliver these options?

4. **Assessment of Affordability**

A. What types of income or wealth should be taken into account when conducting an assessment of affordability for the purposes of a Local Income Tax? What should be excluded? Why?

- *Types of Income/Wealth to consider:*

- *Salary and Wages from Employment*
- *Salary and Wages from Self-Employment*
- *Investment Income – Interest and Dividends*
- *Rental Income*
- *Universal Credit or Legacy Benefits*
- *Child Maintenance*
- *Savings*
- *State, Employer or Private Pensions and Annuities*
- *Equity Release or Pension Drawdown*

B. How could we assess affordability for individuals on fluctuating hours?

E.g. zero hour workers, seasonal workers, overtime industries.

C. What would be the best time period over which to measure income?

Annual, monthly, weekly? Past or future earnings?

D. How could we assess the financial cost of an individual's household circumstances?

For example, number of children or dependants, housing costs, disabilities, caring responsibilities, travel costs, debt repayment.

E. Should there be a minimum income level at which no Local Income Tax is payable? If so, how could this be calculated and kept up to date?

F. Are you familiar with the Single Financial Statement? What are your views on its suitability as a measure of affordability?

G. Do you think the public would be willing to provide details of their income to local authorities? If not, how could this be overcome?

H. How could we ensure that information provided by citizens about their income and circumstances was comprehensive, accurate and up to date?

I. If a Local Income Tax was developed with a clear connection to ability to pay, do you think there would there be a continued need for exemptions, discounts, premiums or the Council Tax Reduction Scheme?

Focus in particular on single person discount, student exemption, disabled person reduction, care leavers' exemption.

The following questions relate to key practical issues which would require resolution or innovation in order to successfully implement a Local Income Tax:

5. Confidentiality and Data Protection

- A. Would it be possible, within the limitations of current data protection legislation, for local authorities to process and hold data on income and household expenditure for the purpose of administering a Local Income Tax?
- B. Would it be possible for the DWP or HMRC to share data with local authorities for the purpose of assessing liability for a Local Income Tax? What would be the limitations or parameters of this kind of data sharing?

6. Transition and Implementation

- A. What are the key factors in an effective transition from the current system of council tax to a Local Income Tax?
E.g. limits on increases in bills, pilot projects, public consultation, deferred payment schemes, staffing, training needs, case management technology
- B. What would be the legislative requirements of the removal of council tax and the introduction of a Local Income Tax?

The following questions relate to key factors that would need to be assessed when considering the impact of the introduction of a Local Income Tax. They would require predictive modelling prior to the implementation of any new tax, as well as ongoing evaluation post-implementation.

7. Fiscal Decentralisation and Benefits of Localism

- A. Would a Local Income Tax improve local democracy and accountability?
- B. Should local authorities be permitted to set their own rate of Local Income Tax and vary their individual rates at will?
- C. Should there be a national cap on rates of Local Income Tax, or a minimum rate?
- D. Would a Local Income Tax system demonstrate a clearer link between taxes paid and services provided in each local authority area? How is this link affected by the national equalisation scheme?
- E. What considerations are there around redistribution of income generated from a local income tax, given the likely capacity of certain local authorities to raise council revenue through a LIT?

8. Winners and Losers

- A. In your view, which groups of people would be disadvantaged by a Local Income Tax? Who would gain from a Local Income Tax?

- B. Any new form of local taxation must at least maintain the value of the current tax base. What data would be required to construct a reliable model of the potential value of a Local Income Tax? Are you aware of any relevant data which could be used?
- C. How could we use data to predict the numbers and demographics of people who would see an increase or decrease in their bill?
- D. Are you aware of data available which include a range of types of income as well as expenditure which may affect affordability?
- E. Are there data available which would allow measurement of the likely impact on issues of inequality?

For example, using the protected characteristics as variables to better understand the full effects of a Local Income Tax.

- F. What tools or technology would be needed to allow the collection of good quality longitudinal data on the progressiveness of the new system, from its inception?

9. Behavioural Change

- A. What are the risks of moving from a system of property taxation to income taxation in terms of taxpayer behavioural responses?

Discuss fiscal flight (particularly from Wales to England, but also between LAs), financial planning, work and savings disincentives, and interaction with other taxes.

10. Public Understanding and Approval

- A. Do you think a local income tax has the potential to be understood by the public?
- B. From our earlier discussions, which form of Local Income Tax do you feel would generate most public support? Why?

Try to bring in issues such as LA having access to their income data vs them providing the information themselves, visibility of the tax.

11. Rates of Compliance and Evasion/Avoidance

- A. What would be the key challenges in terms of ensuring full compliance with a Local Income Tax? How could these be mitigated?

12. Closing Questions

- A. Are there any other issues regarding the implementation of a Local Income Tax in Wales that you believe this project should consider?

- B. Are there any other points you would like to raise?
- C. Is there anyone else you think we should contact regarding this research project?