BALANCE OF FUNDING REVIEW: MEETING 7
PAPER 25: REVIEWING THE CASE FOR A LOCAL INCOME TAX – SUPPLEMENTARY REPORT

Introduction

1. CIPFA's BoF Paper 19, "Reviewing the Case for a Local Income Tax", set out the main implications of introducing a Local Income Tax (LIT), through which local revenues might be collected from individuals, in addition to, or instead of, from households. The Paper:

   - explored some of the key questions and issues which might arise if a LIT was adopted in the UK.
   - concluded that there were many different approaches that could be taken to implementing a LIT, each with distinctive advantages and disadvantages.

2. This Supplementary Paper has been produced in consultation with officials from the ODPM, Treasury, LGA, CBI and other employer and local authority representatives. However, its contents are the responsibility of CIPFA, and the opinions expressed in it do not represent the views of these other organisations.

3. This Paper explores in further detail some of the issues identified in our original Paper in an effort to determine whether a LIT is a practical/workable/affordable option for funding local services and improving the balance of funding.

A Possible Model

4. We believe that it is helpful to begin this report by outlining the features of a possible model for LIT. This helps to capture some of the main conclusions from the work which we have carried out to date. It also provides a basis for explaining in relatively simple terms how LIT might operate. In practice, a significant amount of further detailed work would be necessary to test the feasibility of this model and to validate it as a preferred approach.

5. Our possible model emerges from a careful consideration of three key variables which have been identified during our work:

   - **Key Variable 1: Should LIT replace or supplement the Council Tax?**
     - We concluded in our original Paper and discussions that a model in which LIT supplements the Council Tax has significant advantages. It retains a property taxbase, limits the numbers of potential winners and losers, and offers a realistic prospect of achieving a significant shift in the balance of funding.
   - **Key Variable 2: Who should set the LIT rate?**
     - The more local authorities setting LIT, the more complex the systems and processes required for collecting and allocating its proceeds. Assuming that the Council Tax is retained, we see no need for every Council to set a

LIT. We explain in this Paper that the power to set LIT might realistically be restricted to larger, multi-service authorities i.e. probably Unitaries, Counties, Metropolitan Districts and London Boroughs. All of these Councils (and others), would also retain the power to raise a proportion of their resources via the Council Tax. All relevant taxpayers – irrespective of the local authority structure in the part of the country in which they live – would pay LIT to the single authority responsible for providing the majority of local services. At the same time, they would continue to pay Council Tax to fund the services of several different authorities.

- **Key Variable 3: What level of variability in the rate of LIT would be required?**

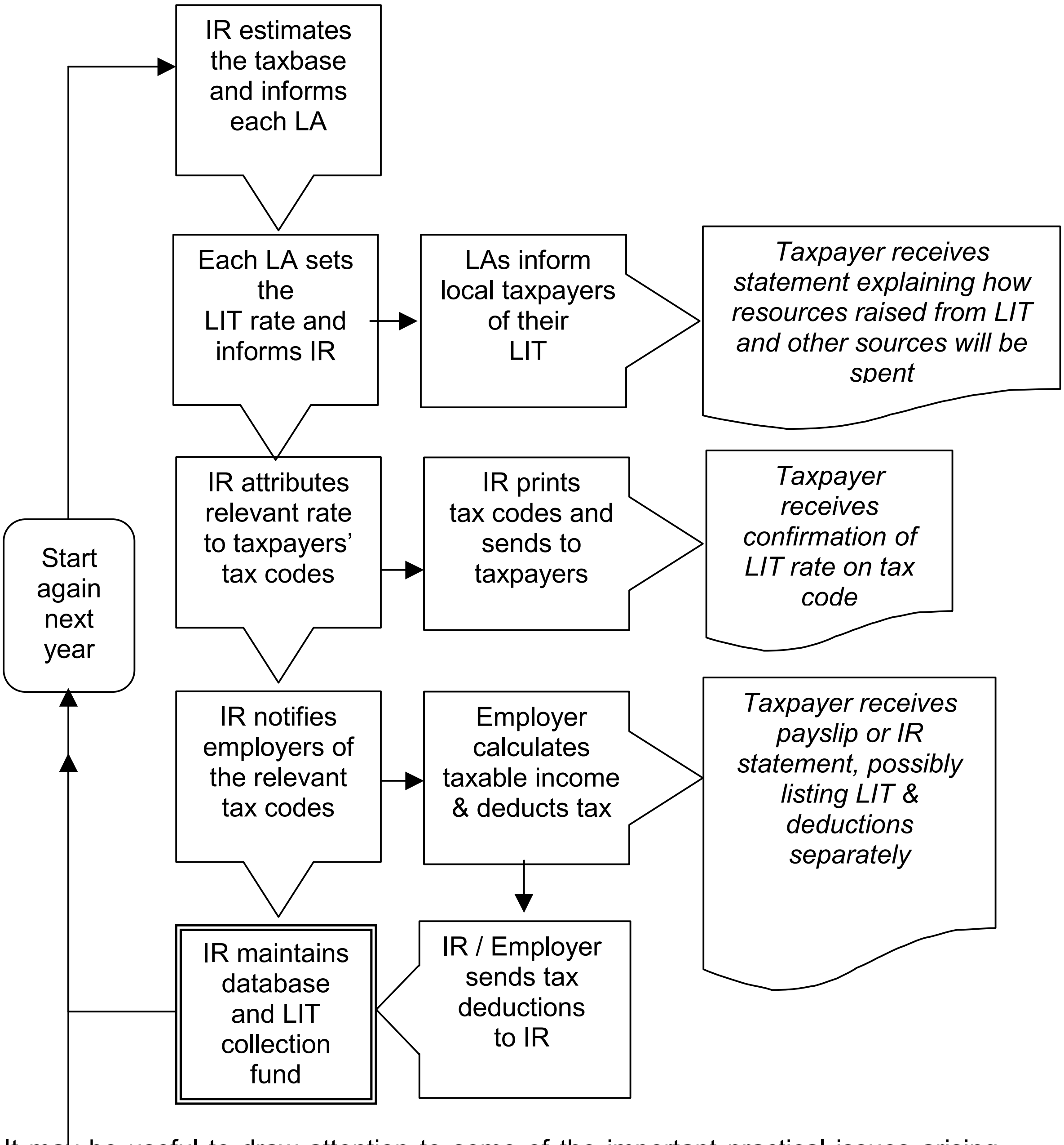
    - As well as limiting the number of Councils setting the LIT, it would also assist and simplify the administration of LIT considerably if the number of LIT rates is carefully limited. Again, if the Council Tax is retained, authorities do not need to set two taxes at very precise rates calibrated to raise an exact sum which reconciles to the Council's budget requirement. Provided that one of the two taxes can be set in this way, the other can be set at more rounded rates. We envisage a scheme in which there might be around five different LIT rates e.g. 2p, 2.5p, 3p, 3.5p, 4p. Relevant Councils would select one of these rates. They would then set a very precise Council Tax rate – no doubt to many decimal places – as at present, in order to raise the balance required to fund the Council's budget.

6. In outlining the features of this possible model, it is also important to stress that we are assuming that national personal income tax will be lowered in parallel with the introduction of LIT and Revenue Support Grant to local authorities will also reduce proportionately.

<u>Overall Operation of LIT</u>

7. Having outlined this relatively simple model, we can now begin to explain in more detail how LIT might operate in practical terms. Figure 1 below is a simple flow diagram illustrating how the system might work, identifying the different roles which would potentially be performed by the three key players – the local authority (LA), the Inland Revenue (IR) and the employer.

Figure 1 - How LIT could be incorporated within the national income tax assessment and collection framework



8. It may be useful to draw attention to some of the important practical issues arising from this flowchart. Firstly, the estimated LIT taxbase would be based upon the Survey of Personal Incomes which inevitably represents the position a number of years earlier (for decisions to be made in October 2004 for the tax year 2005-6, the 2002-3 survey would need to be used).

9. Secondly, the IR do not currently send tax codes to all taxpayers automatically. For example, employees paying tax through the PAYE system, who are not self-assessed and who just receive the personal allowance, would currently be unlikely to receive a tax code notification. If tax codes were sent to all taxpayers under a LIT system, in order to increase the transparency of LIT to the taxpayer, it would therefore be a greater administrative burden for IR and employers.

10. Thirdly, the current system of national income tax operates through the use of tax codes which apply to groups of taxpayers, for example, pensioners aged 65-74. Under a LIT, "individualised tax codes" would be required, as individual taxpayers within a group would be paying different rates of LIT.

11. The existing national tax code comprises three numbers followed by a letter. The first three numbers represent the value of the taxpayer's allowances (in tens of £s). The letter signifies one of a number of groupings of taxpayers. These help to ensure that the relevant adjustments are made efficiently if, for example, the Chancellor makes a change to, say, the single person's allowance.

12. Further characters could be added to the existing code to signify the appropriate LIT rate applying to the taxpayer. This part of the code might therefore refer to one of the five LIT bands suggested earlier. Armed with this information, employers would be able to deduct LIT at the appropriate rate, in effect, adding a local surcharge to the national rates.

13. So, for illustration, a tax code in this new style might be 177L3 where 177 signifies the tax free allowances (£1,770), L signifies the 'taxpayer grouping' (basic personal allowances), and 3 represents the relevant LIT rate (3%). For employers to be able to use the suffix system, local authorities would have to set their budgets and their LIT in good time, before the IR issues tax codes for the following year. Currently, the IR issues tax codes in February for the start of the tax year.

14. The simplicity of this approach is very appealing. It deducts the correct amount of tax at source, in accordance with the tax setting decision taken by the relevant local authority. It avoids the complications of 'nearest band' deductions implicit in other possible LIT models which necessarily require end-of-year reconciliation and adjustment. That said, at the margin, it imposes an increased burden on the Inland Revenue and employers in maintaining and notifying a greater number of individual tax codes.

Underlying Assumptions

15. For clarity, it may be helpful to identify some of the underlying assumptions which are implicit in the model outlined. These are set out below:

- The IR would be responsible for estimating the LIT taxbase for each authority and calculating the yield for a given unit rate of LIT. This would need to take into account a number of variables e.g. income levels, movement of employees, buoyancy etc. Local authorities would receive a guaranteed yield equating to this estimate. The impact of surpluses or deficits arising from variations between local taxbase estimates and actual LIT revenues received would be managed by HM Treasury.

- The relevant local authority area for LIT payment for each taxpayer would be determined at a fixed point in time. For simplicity, this might be the 10 October prior to the tax year, to coincide with the date for registration of residence for electoral purposes. The benefit of fixing a date in this way is that it avoids the necessity to track taxpayer residence throughout the year, to vary LIT rates in-year and to apportion tax receipts between different authorities. Linking tax and electoral timetables also has obvious attractions for public accountability. However, it would still be a very challenging timetable to collect information on a taxpayer's residence on 10 October and for it to be processed in time for the IR coding run. Further work would be required to check whether this would be achievable.

- If there are to be two local taxes – the Council Tax and LIT – it is important that they apply universally across the country. All relevant taxpayers should be taxed in the same way by both systems. However, the prospect of every individual authority setting both taxes is administratively daunting. A more appropriate arrangement might be for:

  (i) All Councils to retain and continue to set the Council Tax.
  (ii) Larger, multi-service councils only (e.g. Unitaries, Counties, Metropolitan Districts and London Boroughs) to set a LIT.

- Given the greater efficiencies achievable via the IR rather than local authorities collecting LIT, the IR would be responsible for maintaining a national LIT collection fund, into which all LIT revenues would be paid. Regular payments would be made from the fund to local authorities in accordance with the estimated taxbase assumptions notified to each authority prior to the commencement of the tax year.

- Surpluses and deficits arising from differences between IR taxbase estimates and actual LIT revenues collected would therefore be managed within the fund. Overall surpluses and deficits on the collection fund as a whole would be managed by HM Treasury. These arrangements would help to limit and manage any volatility in local LIT taxbases which might otherwise be hedged against by authorities setting potentially inflated LIT rates. They would also provide a short-term safety net for authorities experiencing "localised negative buoyancy" resulting from, say, the closure of a very significant local employer. The impact of a sudden sharp fall in the local taxbase would be delayed until the next year or even the year after, depending on the IR's arrangements for updating the estimated taxbase and the timing of that work. Medium and longer-term protection would be provided by the grant system via the long established arrangements for updating local data.

<u>Non-PAYE Income</u>

16. A number of the previously unresolved issues relate to non-PAYE taxpayers and the taxation of income such as interest and dividends. By way of an introduction to these issues, it may be helpful to summarise briefly the current arrangements for assessment and collection of national income tax relating to non-PAYE income.

Self-employment income

- During 2004-5, there is a system of payments on account for the self-employed.
- April 2005 - IR send out Self-Assessment returns for 2004-5.
- 31 January 2006 - Deadline for Self Assessment return for 2004-5 to be submitted to IR without penalties being incurred. This is also the deadline for tax to be paid.
- 31 January 2006 onwards - in the event of an underpayment, if the amount of tax owed falls below a certain level (currently £2,000), the 2006-7 tax code is adjusted. If the taxpayer does not have a tax code or a larger sum is outstanding, payment of the tax due is demanded. If tax has been overpaid, a tax refund is provided.

Interest from banks, building societies and other deposit takers

- In 2004-5, interest is paid in the tax year to individuals and tax is deducted at source by banks/building societies at a 20% rate and paid over to IR. If a non-taxpayer, individuals can ask banks/building societies to pay interest gross.

For those who are sent a tax return:

- April 2005 - IR send out Self-Assessment returns for 2004-5.
- 31 January 2006 - Deadline for Self Assessment return for 2004-5 to be submitted to IR without penalties being incurred. This is also the deadline for tax to be paid.
- Non- or 10p-taxpayers can claim a refund if tax is deducted at source. Higher rate taxpayers pay the excess through the self-assessment system.
- 31 January 2006 onwards - in the event of an underpayment, if the amount of tax owed falls below a certain level (currently £2,000), the 2006-7 tax code is adjusted. If the taxpayer does not have a tax code or a larger sum is outstanding, payment of the tax due is demanded. If tax has been overpaid, a tax refund is provided.

Dividends from shares in UK companies and unit trusts

- In 2004-5, dividends are paid in the tax year to individuals and no tax is deducted at source by companies. However, dividends from companies carry a 10% non-payable tax credit.

For those who are sent a tax return:

- April 2005 – IR send out Self-Assessment returns for 2004-5.
- 31 January 2006 - Deadline for Self Assessment return for 2004-5 to be submitted to IR without penalties being incurred. This is also the deadline for tax to be paid.
- Dividends are charged at 10% for non-, 10p- and basic rate taxpayers, with the 10% tax credit meaning that they have no further tax liability. Unlike interest, however, non- and 10p-taxpayers cannot get a refund, as the tax credit is non-refundable.
- As dividends are charged at 32.5% for higher rate taxpayers, they have an excess 22.5% to pay through the self-assessment system.
- 31 January 2006 onwards - in the event of an underpayment, if the amount of tax owed falls below a certain level (currently £2,000), the 2006-7 tax code is adjusted. If the taxpayer does not have a tax code or a larger sum is outstanding, payment of the tax due is demanded. If tax has been overpaid, a tax refund is provided.

17. Some of the main complications which arise in relation to the possible collection of LIT on non-PAYE income are set out below:

- It would not be possible to fully collect non-PAYE LIT revenues in the tax year to which they relate. In general, the tax on non-PAYE income is assessed and collected in arrears. It would therefore take up to two years before the LIT yield from both PAYE and non-PAYE income was fully realised.

- It is estimated that 8-9 million of the total 31 million taxpayers are currently required to make an end-of-year tax return. The latest IR report shows that, by value, 19% of the net income tax receipts in 2002/03 were collected outside the PAYE system. HM Treasury would need to manage the cashflow implications of providing funding equivalent to the full value of the LIT taxbase to local authorities ahead of the actual receipt of revenues.

- Around 5% of the total income tax liability in 2000/01 derived from tax liabilities on personal investments[1]. In the context of LIT, the key difficulties in relation to investment income lie in matching income to individuals (this is complicated, for example, if nominee accounts are used) and matching income to the appropriate local LIT rate (the address of the taxpayer may not be known at the point at which the tax deduction is made).

- It would currently be very difficult to operate a withholding rate of LIT for investment income i.e. set above the highest rate of LIT, because in contrast to the arrangements in place when Layfield reported, there is currently no withholding tax for dividends.

- In order to include all investment income within a LIT system, it would be necessary to require all taxpayers in receipt of such income to complete an end-of-year tax return. As well as inconveniencing the taxpayers who are currently spared from this obligation, this would place significant and expensive administrative strain on the system.

- Based on the assumption that systems economies and enhancements have reduced the cost of an assessment case to twice that of a PAYE case (the previous assumption made by John Isaac in 1992 was a ratio of 3.5 times the cost), an increase in costs of £1.3bn would arise from this additional burden. It should be stressed that this is very much our best estimate based upon a number of assumptions, and the actual cost could vary substantially from this estimate. This can be compared to the current total cost of income tax collection of £2.2bn. Annex A provides more detail of this calculation.

- In 2000/01, the income tax collected on investment income equated to £5.6bn. As an illustration, for individuals with average incomes, the equated rate of income tax would rise from 15.5% to 17.9% if LIT replaced Council Tax. In these circumstances, the tax yield from investment income would increase by approximately £0.9bn. The potential increased cost of collection of £1.3bn would therefore exceed the expected yield from this source under such a scenario.

- Disregarding investment income from the calculation of LIT therefore has significant administrative attractions, although, of course, it appears to be a regressive step. In practice, however, it does not necessarily represent any change in terms of the rate of taxation on different streams of income. Earned income would be subject to two levels and rates of income tax – national and local – which in aggregate would equate broadly to the current national rate. Investment income would be subject to one (potentially unchanged) level and rate of income tax – the current national system.

[1] IR Table 3.7 – Investment income tax liabilities of starting, “savers”, basic and higher rate taxpayers. The sum of investment income across all these categories was £5.562bn within a total liability of £105.6bn.

Refinements to Initial Costings for LIT

Set-up costs for IR and local authorities

18. Since the presentation of BoF Paper 19 to the Review Group, estimates have been made of the initial set-up costs of LIT to the IR and local authorities. It is important to stress that these are, however, based upon a number of broad assumptions. They therefore represent an order of magnitude assessment of such costs, with considerable scope for actual costs to vary significantly.

19. Annex B outlines the assumptions relating to these costs, which are summarised below (to the nearest £10m).

	£m
Initial database preparation and new IT systems	90
Training and consultation	240
Total	**330**

20. Staff severance and restructuring costs would also arise in the event that LIT replaces rather than supplements Council Tax. These costs are estimated to be approximately £70m and are also shown in Annex B. Some of the key issues relating to these set-up costs are discussed below.

Initial database preparation and new systems

21. A register of taxpayers would need to be compiled showing an address for correspondence purposes and residential address, in order to reference the appropriate LIT rate. The database would need to be designed to incorporate the capability to cross-reference details relating to the national personal income tax assessments, national insurance details for benefits-checking purposes and, possibly, the electoral register to verify residency.

22. It is envisaged that the following minimum analysis would be required for each taxpayer:

- Name
- Address of residence at 10 October
- Address for correspondence purposes
- Date of birth
- NI number
- Tax reference
- Tax code
- LIT area code and LIT band

23. Two main costs would arise in preparing this database: collating the data and installing the equipment and software. In relation to the former, it is assumed that most of the above information is already held on existing systems, and that the substantial effort in collating these can take place over a period of approximately one year, much of it incorporated within normal administrative procedures i.e. at each relevant stage in a procedure, a copy reference could be posted to the central database of the IR.

24. An initial set of records currently exists for correspondence purposes for all taxpayers. In updating these, each taxpayer could be asked to complete a form

providing any of the missing information outlined above. It is possible that a substantial part of this procedure could be accommodated within existing administrative costs, although this would need to be tested. Clearly some investigative effort would be required to trace those taxpayers not replying to the registration correspondence.

25. In our view, the cost of this work should be similar to that of the annual exercise of preparing the electoral register. On this basis, it is estimated to be a one-off cost of the order of £50m.

26. The IR has outsourced the management of IT resources with an annual contract value of £300m. The costs of enhancing IT equipment for IR IT suppliers (EDS/Accenture etc), are assumed to be a one-off cost of around 12.5% of this total, suggesting an estimate of the order of £40m.

Training and consultation

27. Introductory training is estimated to cost around £10m. There would also be a cost relating to publicity and consultation with employers and, based upon 1.3 million PAYE employers, this is estimated to be approximately £80m. A more significant cost, however, is likely to be publicity and consultation with the 30.7 million taxpayers themselves, which is estimated to be approximately £150m.

Severance and restructuring costs

28. The most likely scenario for the operation of LIT would be as a supplement to Council Tax. However, for completeness, the severance and restructuring costs for staff, if Council Tax were to be abolished, have also been estimated. These are likely to be in the order of £70m in total; £10m for IR and the Valuation Office and £60m for local authorities.

Timing of LIT implementation

29. In terms of the timing of the implementation of LIT, it is estimated that the drafting and passage of relevant legislation might take a minimum of two years. It should also be noted that in some cases, where significant expenditure on the development of new systems and policies is required before the main legislation goes through Parliament, a paving bill is introduced earlier to authorise such expenditure. A paving bill was brought in, for example, before the Working Families Tax Credit was introduced - the Tax Credits (Initial Expenditure) Act 1998 - which allowed the Inland Revenue to incur expenditure on replacing Family Credit.

30. Full commitment to investment in appropriate systems to support a LIT might, however, be delayed for a period, pending a clear legal and policy basis on which to proceed. Bearing in mind the actions and preparation required, listed in our previous report, it is considered that the elapsed time needed would broadly be as follows:

Initially:	2-years to complete legislative requirements
Then:	1-year for systems preparations; and, in parallel, 2-years for consultation and testing.

31. A realistic timescale would therefore be likely to be a minimum of four years before a LIT could be operational.

Ongoing costs of LIT

32. In our previous report, we estimated these ongoing costs to be between £230-370m if LIT supplemented Council Tax, with savings of between £140m-£280m if LIT replaced Council Tax entirely. In this report, Annex A identifies the potentially very significant costs associated with attempting to fully include investment income within the scope of LIT.

Choosing a Pre-Determined LIT Rate

33. This report has majored on a LIT model in which local authorities would choose from a range of, say, five pre-determined LIT rates. In making that choice, authorities would no doubt take into consideration the assumed 'matching reduction' in national LIT rates. The latter will reflect an assessment of the many individual decisions which Councils will take across the country.

34. So, for example, Councils might be offered a choice between five rates set at 2p, 2.5p, 3p, 3.5p and 4p and the Chancellor might reduce national rates by 3p in the £ on the assumption that this will be the average rate of LIT across the country.

35. In making their decisions, Councils will no doubt consider how they wish to compare alongside the Chancellor's national adjustment. A LIT set at 3p will clearly be neutral, signalling 'no change' in the overall tax burden. In contrast, decisions in favour of 3.5p or 4p will represent net increases in taxation and choices in favour of 2p or 2.5p will represent net reductions.

36. Councils are also likely to consider their position relative to other authorities, for example, whether they would potentially be perceived (or labelled) as a high or low tax area.

37. These decisions will also be complicated by the potential knock-on implications for Council Tax rates. In effect, Councils will be able to decide whether they prefer to tax incomes or property, unless the Government chooses to limit or regulate this discretion.

Adopting a "Nearest Band" Approach

38. In our previous report, we countenanced the possibility of very large numbers of LIT setting authorities, with LIT perhaps replacing Council Tax. Recognising that it might be administratively difficult to operate a system involving several hundred unique tax rates, we discussed the possibility of a "nearest band" approach, which would round Councils' tax rates to the nearest rung on a ladder of fixed LIT rates. Taxpayers would therefore pay approximately, but not precisely, the right amount of LIT. End of year reconciliations would determine the small amount of tax under or over paid by each taxpayer, which in most circumstances would be carried forward to the following year's tax assessment.

39. This approach remains a valid option, but we believe that it would be significantly more difficult to explain to taxpayers and to administer than the model based on a small number of pre-determined rates from which tax setting authorities would choose.

Limiting the Power to Set LIT to Selected Classes of Authority

40. This Paper assumes a model in which LIT supplements the Council Tax. In such a scenario, it does not necessarily follow that all authorities would set both taxes. What is important is that all relevant taxpayers are subject to both taxes.

41. Far from creating a difficulty, this presents a significant opportunity. It opens the door to an arrangement in which one authority only in any given area would have the power to levy a LIT. Because of the non-uniform structures of local government across the country, this points to a number of different LIT setting classes of authority, in all probability, Unitaries, Counties, Metropolitan Districts and London Boroughs. These authorities would also retain Council Tax setting powers, as would all other authorities.

42. These arrangements facilitate the "choice of predetermined rates" approach explained in paras 33-37 above. Because only one authority is setting the LIT, there is no question of trying to aggregate the LIT decisions of several Councils. In addition, because the Council Tax is available as another source of income, there is no requirement to calibrate the rate of LIT to reconcile exactly with the Council's budget requirement.

43. The Council Tax rates set by different classes of authority would potentially vary significantly from those currently operable. County Council rates would, for example, be likely to be somewhat lower, reflecting the availability of new LIT powers. Shire District rates, on the other hand, would probably be somewhat higher, reflecting the non-availability of LIT powers to these authorities, and the assumption that grant support from Government (to all authorities) will reduce, reflecting the shift in the balance of funding.

44. For completeness Annex C considers and exemplifies further models which could be used to set different numbers of LIT rates.

The assessment of additional burdens to employers of LIT

45. The CBI and the Institute of Payroll and Pensions Management (IPPM) have been consulted on the potential additional burdens to employers of a LIT. The key issues arising are summarised below:

- There would clearly be an increase in the compliance burden upon employers as a result of the advent of LIT. The extent of this burden will vary according to the level of complexity associated with LIT. This can be mitigated by measures such as limiting the number of LIT rates and reducing the number of authorities able to levy a LIT.

- The extent of the additional burden of LIT would also be dependent upon the nature of employers and employment. For example, the burden would be likely to be greater for:

  - organisations with national coverage, such as the retail and banking sector, which are likely to have employees resident in all local authority billing areas;
  - employers where there is high staff turnover or a large proportion of casual/short-term/seasonal workers;
  - employers in metropolitan areas where employees are more likely to be resident in a larger number of local authority areas;

  - smaller firms not using electronic data interfaces and which run manual payrolls.

- The IPPM estimates that employees will, on average, be located in the following numbers of different local authority areas, according to the size of the enterprise:

1-10 employees	2 areas
11-50 employees	4 areas
51-250 employees	10 areas
251 or more employees	15 areas
1000+	All areas

- A major issue will be the capacity of current IT systems to deal with a number of LIT rates. The CBI's view is that current IT capacity may only be able to deal with 3 or 4 rates.

- The key point of contact for employers would need to be the IR, to avoid the complexities involved with communicating with up to 434 local authorities, although this number could be reduced if LIT was restricted to larger, multi-service authorities.

- It would be helpful for employers to make single payments to the IR for national income tax and LIT. It would, however, reduce accountability and transparency for taxpayers if these two deductions were not separately and clearly identified on the employee's payslip.

- It will be important to define earnings for LIT purposes very clearly. There are already at least five definitions of earnings that employers deal with i.e. taxable, NI'able, tax creditable, superannuable, attachable.

46. Based upon the assumption that IR would be responsible for administering a LIT, employee and other associated costs for employers are assumed to increase by 20% and 10% respectively. The estimated additional costs of LIT for employers, by number of employees, are shown in Annex D.

47. The total cost to employers of LIT is therefore estimated to be over £110m, at current prices. This would be in addition to the costs to employers of administering the current PAYE system which have been estimated at £800m[2].

The Implications for the Local Authority Budget and Tax Setting Timetable of LIT

48. In the current national PAYE system, the Inland Revenue determines tax codes in January/February and notifies tax codes to employers before the start of the tax year (6 April). Tax codes can be updated to take account of the Chancellor's budget in March, with employers then inputting revised tax codes to take effect in the pay period following mid-May. In these circumstances, tax is clearly being collected on a current basis, i.e. in the year to which it relates for PAYE income.

49. Billing authorities in England and Wales must approve their budgets by 11 March (with the budget setting timetable in Scotland being around 1 month earlier than in England). There is a legislative requirement for Council Tax bills to be sent to

[2] The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995-96, Report by the Centre for Fiscal Studies, University of Bath, 1998.

taxpayers 14 days before the first due date. As with national taxation, this therefore allows tax to be collected in the year to which it relates.

50. In considering the overall operation of LIT, it is assumed that local authorities would notify the Inland Revenue of their LIT rates, and that the Inland Revenue in turn would notify tax codes reflecting the appropriate LIT rates to employers. The key issue in respect of LIT, therefore (if tax is to be collected in the year to which it relates for PAYE income) is that sufficient time must be available between the notification of LIT rates by local authorities to the Inland Revenue and the determination of correct tax codes and their notification to employers.

51. The key difficulty lies in the greater administrative burden for the IR and employers of an increased number of "individualised tax codes". The current national taxation system works on the basis that tax codes for certain groupings of taxpayers can all be uplifted at once following changes announced in to the Chancellor's Budget. Under LIT, however, taxpayers in the same group may be paying say, 5, different LIT rates. The system will therefore need to cope with many more different codes than previously.

52. If local authorities were able to set their budgets earlier, and therefore provide earlier notification to the Inland Revenue, this would allow more tax codes to be processed towards the start of the tax year. However, this in turn would create a need for earlier Government announcements of revenue support grant and specific grants for the following year.

53. Unfortunately, it has not been possible to estimate with any precision the extent to which local authority budget timetables (and associated announcements by Government) would need to be brought forward to provide the Inland Revenue and employers with adequate margins to assess, process and implement all of the relevant tax code changes resulting from the announcement of new LIT rates each year.

54. The alternative solution to this timing problem - delaying commencement of the collection of LIT until later in the year, and therefore collecting it over a shorter period - is likely to be very unpopular with taxpayers. It also has cashflow implications for the national LIT collection fund.

<u>Coverage of LIT – Pan-UK or England Only?</u>

55. Our original report took the stance that LIT would logically be introduced simultaneously across the whole of the UK. The principal argument in favour of that approach concerned the avoidance of "cliff-edges". Although it may be difficult to predict in detail, the operation of significantly different tax regimes in adjacent areas will inevitably encourage "avoidance behaviour".

56. In this report, we have developed a more explicit possible model for LIT. This helps to tease out further administrative and perceived equity difficulties which would also arise if LIT is introduced in England only.

57. Consider, for example, areas around the England/Scotland border. On the English side of the border, taxpayers would pay the Council Tax, LIT and (reduced) rates of national income tax. On the Scottish side, however, they would pay Council Tax and (unchanged i.e. higher rates of) national income tax only. In effect, a LIT option would be available in Scotland (up to 3p on the standard rate of tax), but in the event of a decision by the Scottish Parliament to activate these powers, national rates of tax

would not be reduced. The potential for confusion and perceptions of unfairness are obvious.

58. Even discounting the possibility of perverse behaviour, many residents of English authorities will work over the border in Scotland. Potentially, these employees will avoid LIT, although they will be paying broadly the right level of taxes because unchanged national income tax rates will presumably apply in Scotland.

59. In these circumstances the local authorities concerned will “lose” a significant proportion of their local tax revenue. In practice, this might be managed at the national level via the suggested arrangements for the Inland Revenue to “guarantee” the estimated LIT taxbase by paying over the value of the estimated LIT yield. But again, the risk of these arrangements being misunderstood, with perceptions of unfairness, are considerable.

60. For these reasons we continue to hold the view that, in the event of the adoption of a system of LIT, pan-UK implementation would be desirable.

ANNEX A
Assessing the Potential Cost of a "Universal End-Year Tax Assessment"

Note: Figures below are based upon best estimate assumptions and actual costs could vary from this figure.

Adopting Universal Assessment could effectively double the existing cost of collecting Income Tax. i.e. the current cost of £2.2bn could, potentially, increase to as much as £4.6bn, assuming the same ratio of processing costs estimated by John Isaac, the former Deputy Chairman of the IR.

However, we consider that considerable economies and enhancements in systems will have produced productivity improvements in the intervening years since this ratio was quoted in 1992. If it is assumed that the cost of an assessment case has reduced to, say, twice the cost of a PAYE case since Isaac estimated the ratio at 3½ times, then the total cost would rise to £3.5bn – i.e. an increase over the current cost of £1.3bn (£3.5 - £2.2bn). This is shown below.

Cost of collecting PIT now	= £2,240 m				
Let P = PAYE cases					
Let A = Assessment cases					
	8.5(A)	+	22.2(P)	=	2240
and, according to John Isaac, assessment cases cost about 3½ times as much to process as PAYE cases[†].					
so,			A	=	3.5(P)
Therefore,	8.5(A)	+	22.2/3.5(A)	=	2240
			14.9(A)	=	2240
			A	=	150
and,			P	=	A/3.5
			P	=	42.9
There are 30.7 million taxpayers, so					
"Universal Assessment" would cost			30.7(A)	=	4605
or, assuming a ratio of 2 rather than 3.5				**=**	***3509***
and, if all tax was deducted at source,					
as per PAYE, the cost would be			30.7(P)	=	1317

† "A local income tax – a study of the options", AJG Isaac, Joseph Rowntree Foundation, 1992 – see page 21.

ANNEX B
Preparation and Transitional Costs Involved in the Introduction of LIT

Note: All costs based upon broad assumptions and figures only illustrate an order of magnitude.

[Estimates to nearest £10m]	**£m**	
New systems and initial database preparation	**90**	
Cost of training and consultation	**240**	(employers, IR & public)
	330	

Estimated cost of collating LIT register of taxpayers		
Assumed to cost the same as maintenance of the Electoral Roll		£54,000,000
	Say,	**£50m**
Cost of enhancing IT equipment for IR IT suppliers (EDS / Accenture / etc)		
Current cost of IT support contract		£300,000,000
Say one-off @12.5%		£37,500,000
	Say,	**£40m**
Cost of Staff preparation and training within IR		
Say number of assessment staff		51,000
2 days training each		£10,821,273
	Say,	**£10m**
Publicity and consultation with employers		
Number of PAYE employers		1,300,000
Say, £60 per employer for training packs		78,000,000
	Say,	**£80m**
Publicity and consultation with taxpayers		
Number of taxpayers		30,700,000
Say, £5 per taxpayer (3 mail-shots and brochure)		153,500,000
	Say,	**£150m**

Total severance costs		**£70m**	
Severance costs for IR / VO on abolition of CT			
Valuation Office Staff		3,812	
Assume 50% Council Tax		1,906	(rest relates to NNDR)
Average salary		23,340	
Severance costs at 25% of salary		£11,121,510	
	Say,	**£11m**	
Severance costs for LAs on abolition of CTx.			
CTx Revs & Bens Staff		13,500	
Say, 25% needed for NNDR		10,125	
Average salary		23,340	
Severance costs at 25% of salary		£59,079,375	
	Say,	**£60m**	

ANNEX C
Examining the Effects of Setting Different Numbers of Local Income Tax Rates

For illustrative purposes, the banding options have been exemplified to identify their effects on the amount of LIT revenue collected[3]. It should be noted that a number of assumptions have been made for each of these exemplifications, and that any change to these assumptions will lead to changes in the resulting surpluses and deficits. These exemplifications are shown in Tables 1, 2 and 3 and the key issues arising are summarised below.

Setting an optimum number of rates

A decision could be taken regarding the optimum number of rates that both the Inland Revenue and businesses could realistically deal with. For the purposes of this Paper, the range between the lowest and highest assumed LIT rate has been identified, in order to calculate the gap required between these rates to produce a specific number of evenly spaced LIT bands.

Table 1 shows the results at regional and class level of reducing the number of rates to 20, 30 and 40 LIT rates. The larger the gap between the precise rate required and the LIT rate actually levied, the greater the potential deficits and surpluses. Therefore, at the local authority level, deficits and surpluses are greatest when the number of rates is reduced to 20.

Rounding

Under this option, the LIT rates are rounded to a specific number of decimal places. As with scaling factors in the Revenue Grant Distribution system, LIT rates would initially need to be calculated to a large number of decimal places in order for the exact local revenue requirement to be reached.

Table 2 exemplifies the effects of rounding to 1 and 2 decimal places as well as to the nearest pence. Each reduction in decimal place leads to a smaller number of rates, with the precise number of rates varying depending upon the range of rates. Inevitably, the greater the rounding, the greater the potential surpluses and deficits in the LIT requirement. The figures in Table 2 show that there is no consistency to the pattern of regional/class of authority "winners" and "losers".

Regional rates

The implications of LIT rates set at a regional level are also considered. Table 3 shows the exemplifications for regional rates being applied to each local authority. These have been applied to both rounded and unrounded rates. It should be noted that rounding may lead to fewer than the 12 regional rates of LIT.

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[3] These exemplifications are based on LIT rates required to meet 2003/04 Council Tax requirements prior to any change to the Revenue Grant Distribution system. As presented in the CIPFA BoF Paper (19), "Reviewing the Case for a Local Income Tax", March 2004, the rates are based on median salary.

In this case there does appear to be more consistency about the pattern of regional/class of authority "winners" and "losers". In the event of the adoption of a LIT system linked to regional rates, this issue would require further investigation.

ANNEX C
TABLE 1: THE EFFECT OF SETTING A SPECIFIC NUMBER OF LOCAL INCOME TAX RATES

	2003/04 Gross council tax requirement	Reduced to 20 bands			Reduced to 30 bands			Reduced to 40 bands		
		Yield	Deficit / surplus		Yield	Deficit / surplus		Yield	Deficit / surplus	
	£000	£000	£000	%	£000	£000	%	£000	£000	%
England	21,922,841	21,890,970	-31,871	-0.1%	21,927,356	4,514	0.0%	21,889,587	-33,254	-0.2%
Inner London	963,584	987,287	23,703	2.5%	958,747	-4,837	-0.5%	958,971	-4,613	-0.5%
Outer London	1,991,243	1,977,883	-13,360	-0.7%	1,989,563	-1,680	-0.1%	1,984,860	-6,383	-0.3%
Met Districts	3,572,676	3,553,939	-18,737	-0.5%	3,588,229	15,553	0.4%	3,563,944	-8,732	-0.2%
Shire Unitaries	2,866,930	2,836,607	-30,323	-1.1%	2,864,471	-2,459	-0.1%	2,858,397	-8,533	-0.3%
Shire Districts	9,550,695	9,554,317	3,622	0.0%	9,534,999	-15,696	-0.2%	9,534,232	-16,463	-0.2%
Welsh Unitary	860,978	866,543	5,565	0.6%	863,676	2,698	0.3%	861,587	609	0.1%
Scottish Unitary	1,833,230	1,830,300	-2,930	-0.2%	1,841,227	7,997	0.4%	1,841,380	8,150	0.4%
Northern Ireland	282,567	283,192	625	0.2%	285,559	2,992	1.1%	285,242	2,675	0.9%
South West	2,004,383	1,997,790	-6,593	-0.3%	2,004,361	-22	0.0%	1,999,896	-4,487	-0.2%
South East	3,414,660	3,390,927	-23,733	-0.7%	3,410,975	-3,685	-0.1%	3,419,201	4,541	0.1%
London	2,954,827	2,965,170	10,343	0.4%	2,948,310	-6,517	-0.2%	2,943,831	-10,996	-0.4%
Eastern	2,208,836	2,215,453	6,617	0.3%	2,207,301	-1,535	-0.1%	2,198,637	-10,199	-0.5%
East Midlands	1,518,258	1,513,856	-4,402	-0.3%	1,516,497	-1,761	-0.1%	1,513,378	-4,880	-0.3%
West Midlands	1,869,102	1,876,076	6,974	0.4%	1,873,023	3,921	0.2%	1,859,627	-9,475	-0.5%
Yorkshire and Humber	1,655,433	1,644,193	-11,240	-0.7%	1,661,317	5,884	0.4%	1,651,394	-4,039	-0.2%
North East	878,692	870,925	-7,767	-0.9%	881,600	2,908	0.3%	877,772	-920	-0.1%
North West	2,441,875	2,436,544	-5,331	-0.2%	2,433,509	-8,366	-0.3%	2,437,642	-4,233	-0.2%
Wales	860,978	866,543	5,565	0.6%	863,676	2,698	0.3%	861,587	609	0.1%
Scotland	1,833,230	1,830,300	-2,930	-0.2%	1,841,227	7,997	0.4%	1,841,380	8,150	0.4%
Northern Ireland	282,567	283,192	625	0.2%	285,559	2,992	1.1%	285,242	2,675	0.9%
Minimum	938	900	-9,634	-11.8%	885	-4,580	-8.8%	974	-4,482	-6.9%
Maximum	303,273	307,356	7,644	10.9%	313,107	9,834	9.1%	300,327	3,521	7.5%
Number of LIT rates		19			27			34		

ANNEX C
TABLE 2: THE EFFECT OF ROUNDING LOCAL INCOME TAX RATES

	2003/04 Gross Council Tax requirement	Rounded to 2 decimal places			Rounded to 1 decimal place			Rounded to 1 pence*		
		Yield	Deficit / surplus		Yield	Deficit / surplus		Yield	Deficit / surplus	
	£000	£000	£000	%	£000	£000	%	£000	£000	%
England	21,922,841	21,922,147	-694	0.00%	21,916,445	-6,396	-0.03%	22,037,926	115,085	0.52%
Inner London	963,584	963,391	-193	-0.02%	958,867	-4,717	-0.49%	994,856	31,272	3.25%
Outer London	1,991,243	1,990,952	-291	-0.01%	1,993,327	2,084	0.10%	1,972,875	-18,368	-0.92%
Met Districts	3,572,676	3,573,033	357	0.01%	3,572,273	-403	-0.01%	3,607,439	34,763	0.97%
Shire Unitaries	2,866,930	2,866,804	-126	0.00%	2,867,655	725	0.03%	2,853,018	-13,912	-0.49%
Shire Districts	9,550,695	9,550,056	-639	-0.01%	9,546,668	-4,027	-0.04%	9,620,662	69,967	0.73%
Welsh Unitary	860,978	861,107	129	0.01%	863,688	2,710	0.31%	850,885	-10,093	-1.17%
Scottish Unitary	1,833,230	1,833,281	51	0.00%	1,830,081	-3,149	-0.17%	1,858,482	25,252	1.38%
Northern Ireland	282,567	282,586	19	0.01%	282,949	382	0.14%	278,931	-3,636	-1.29%
South West	2,004,383	2,004,402	19	0.00%	2,003,328	-1,055	-0.05%	2,021,165	16,782	0.84%
South East	3,414,660	3,414,256	-404	-0.01%	3,414,234	-426	-0.01%	3,418,037	3,377	0.10%
London	2,954,827	2,954,343	-484	-0.02%	2,952,194	-2,633	-0.09%	2,967,731	12,904	0.44%
Eastern	2,208,836	2,208,313	-523	-0.02%	2,210,995	2,159	0.10%	2,243,800	34,964	1.58%
East Midlands	1,518,258	1,518,258	-0	0.00%	1,516,077	-2,181	-0.14%	1,537,950	19,692	1.30%
West Midlands	1,869,102	1,869,290	188	0.01%	1,865,208	-3,894	-0.21%	1,874,140	5,038	0.27%
Yorkshire and Humber	1,655,433	1,655,384	-49	0.00%	1,657,328	1,895	0.11%	1,642,385	-13,048	-0.79%
North East	878,692	878,580	-112	-0.01%	878,534	-158	-0.02%	863,560	-15,132	-1.72%
North West	2,441,875	2,442,348	473	0.02%	2,441,827	-48	0.00%	2,480,860	38,985	1.60%
Wales	860,978	861,107	129	0.01%	863,688	2,710	0.31%	850,885	-10,093	-1.17%
Scotland	1,833,230	1,833,281	51	0.00%	1,830,081	-3,149	-0.17%	1,858,482	25,252	1.38%
Northern Ireland	282,567	282,586	19	0.01%	282,949	382	0.14%	278,931	-3,636	-1.29%
Minimum	938	939	-137	-0.26%	935	-2,946	-2.01%	780	-22,373	-32.68%
Maximum	303,273	303,522	249	1.49%	300,327	2,109	1.98%	319,497	19,483	227.40%
Number of LIT rates		288	288	288	73	73	73	10	10	10

Notes: *Corporation of London rounded up to 1 pence

ANNEX C
TABLE 3: THE EFFECTS OF APPLYING REGIONAL LIT RATES

	Not rounded				Rounded to 2 decimal places			
	Rate	Yield £000	Deficit / surplus £000	%	Rate	Yield £000	Deficit / surplus £000	%
England		21,922,841	0	0.0%		21,924,251	1,410	0.0%
Inner London		1,092,749	129,165	13.4%		1,092,615	129,031	13.4%
Outer London		1,862,078	-129,165	-6.5%		1,861,850	-129,393	-6.5%
Met Districts		3,657,412	84,736	2.4%		3,657,413	84,737	2.4%
Shire Unitaries		3,023,509	156,579	5.5%		3,023,870	156,940	5.5%
Shire Districts		9,308,367	-242,328	-2.5%		9,307,371	-243,324	-2.5%
Welsh Unitary		860,978	0	0.0%		861,040	62	0.0%
Scottish Unitary		1,833,230	0	0.0%		1,835,120	1,890	0.1%
Northern Ireland		282,567	0	0.0%		283,020	453	0.2%
South West	5.0053	2,004,383	0	0.0%	5.01	2,006,248	1,865	0.1%
South East	3.9618	3,414,660	0	0.0%	3.96	3,413,148	-1,512	0.0%
London	3.7305	2,954,827	0	0.0%	3.73	2,954,465	-362	0.0%
Eastern	4.3444	2,208,836	0	0.0%	4.34	2,206,574	-2,262	-0.1%
East Midlands	4.9070	1,518,258	0	0.0%	4.91	1,519,194	936	0.1%
West Midlands	4.7283	1,869,102	0	0.0%	4.73	1,869,774	672	0.0%
Yorkshire and Humber	4.9008	1,655,433	0	0.0%	4.90	1,655,177	-256	0.0%
North East	5.6164	878,692	0	0.0%	5.62	879,252	560	0.1%
North West	4.9613	2,441,875	0	0.0%	4.96	2,441,239	-636	0.0%
Wales	3.7597	860,978	0	0.0%	3.76	861,040	62	0.0%
Scotland	4.5153	1,833,230	0	0.0%	4.52	1,835,120	1,890	0.1%
Northern Ireland	2.6657	282,567	0	0.0%	2.67	283,020	453	0.2%
Minimum	2.6657	1,951	-76,722	-51.3%	2.67	1,953	-76,569	-51.3%
Maximum	5.6164	302,136	83,513	1121.3%	5.62	302,244	83,495	1121.2%
Number of LIT rates	12				12			

	Rounded to 1 decimal place				Rounded to 1 pence			
	Rate	Yield £000	Deficit / surplus £000	%	Rate	Yield £000	Deficit / surplus £000	%
England		21,916,449	-6,392	0.0%		22,528,035	605,194	2.8%
Inner London		1,083,827	120,243	12.5%		1,171,705	208,121	21.6%
Outer London		1,846,876	-144,367	-7.3%		1,996,622	5,379	0.3%
Met Districts		3,662,062	89,386	2.5%		3,762,376	189,700	5.3%
Shire Unitaries		3,028,126	161,196	5.6%		3,050,414	183,484	6.4%
Shire Districts		9,310,209	-240,486	-2.5%		9,280,969	-269,726	-2.8%
Welsh Unitary		870,200	9,222	1.1%		916,000	55,022	6.4%
Scottish Unitary		1,827,000	-6,230	-0.3%		2,030,000	196,770	10.7%
Northern Ireland		286,200	3,633	1.3%		318,000	35,433	12.5%
South West	5.00	2,002,244	-2,139	-0.1%	5.00	2,002,244	-2,139	-0.1%
South East	4.00	3,447,624	32,964	1.0%	4.00	3,447,624	32,964	1.0%
London	3.70	2,930,702	-24,125	-0.8%	4.00	3,168,327	213,500	7.2%
Eastern	4.30	2,186,237	-22,599	-1.0%	4.00	2,033,709	-175,127	-7.9%
East Midlands	4.90	1,516,099	-2,159	-0.1%	5.00	1,547,040	28,782	1.9%
West Midlands	4.70	1,857,915	-11,187	-0.6%	5.00	1,976,505	107,403	5.7%
Yorkshire and Humber	4.90	1,655,177	-256	0.0%	5.00	1,688,956	33,523	2.0%
North East	5.60	876,123	-2,569	-0.3%	6.00	938,703	60,011	6.8%
North West	5.00	2,460,927	19,052	0.8%	5.00	2,460,927	19,052	0.8%
Wales	3.80	870,200	9,222	1.1%	4.00	916,000	55,022	6.4%
Scotland	4.50	1,827,000	-6,230	-0.3%	5.00	2,030,000	196,770	10.7%
Northern Ireland	2.70	286,200	3,633	1.3%	3.00	318,000	35,433	12.5%
Minimum	2.70	1,949	-77,225	-51.6%	3.00	1,949	-60,848	-50.1%
Maximum	5.60	300,327	82,300	1111.4%	6.00	319,497	94,243	1209.6%
Number of LIT rates	10				4			

ANNEX D
Assumed Additional Costs of LIT for Employers

	COSTS		
	Employee	Other	Total
	£m	£m	£m
1-4 employees	44.9	25.4	70.3
5-9 employees	6.0	4.9	10.9
10-49 employees	10.4	6.8	17.2
50-99 employees	2.1	1.8	3.9
100-499 employees	3.2	3.6	6.8
500-999 employees	0.8	0.9	1.7
1000-4999 employees	2.0	1.3	3.3
5000+ employees	0.1	0.4	0.5
Total	**69.5**	**45.1**	**114.6**