

fresh thinking

Scotland's future - a dead loss?

In their second submission to the Scottish Local Government Finance Review, Fred Harrison and Peter Gibb set out something of the bigger picture for fiscal reform

Most conventional taxes impose a ceiling on economic growth. Wealth and welfare are damaged by the disincentive effects of taxes on earned incomes, on investments, and on people's savings. These taxes impose an 'excess burden' which inflict 'deadweight losses' on the wider economy. The UK Treasury's term for this loss of wealth and

(excluding North Sea oil) also contribute £5.2bn, which delivers a further deadweight loss of £1.6bn.

These five categories of taxation, therefore, deprive the people of Scotland, every year, of wealth and welfare equal to almost five and a half billion pounds.

If Scotland's revenue was raised with

the aid of public charges on the rental value of land, the economy would be free of deadweight losses. The academic literature is replete

with assurances that revenue collected from rents does not distort economic incentives. In other words, as Adam Smith noted in *The Wealth of Nations*, land value is "a peculiarly suitable" source of public revenue.

Consider, for example, what would happen if the Scottish Parliament exercised its powers to vary the basic rate of Income Tax by up to three pence. *Decreasing* the rate by that amount would reduce revenue from this source by £630m. To maintain public services, the sum could be raised instead by increasing the revenue collected from the rental value of land. The total tax take would remain the same. But this would not be a revenue 'neutral' shift. By reducing the Income Tax burden on Scottish wage and

salary earners, deadweight losses within the economy would be reduced. £189m is the additional wealth and welfare that would accrue to Scotland as a result of reducing in this way the damage that is currently inflicted on the national economy by Income Tax.

Using the Treasury's SOCEF measure, the deadweight loss of the current system of Council Tax and Non-Domestic Rates, alone, is estimated to be in the region of £569m. This is the opportunity cost to the Scottish economy of a halted evolution of its system of local government finance.

And the introduction of Local Income Tax, as some are advocating, would only further increase the deadweight burden on the Scottish economy caused by local taxation, to around £948m. These last two figures are likely to under-state the detrimental impact of LIT, as we discuss later.

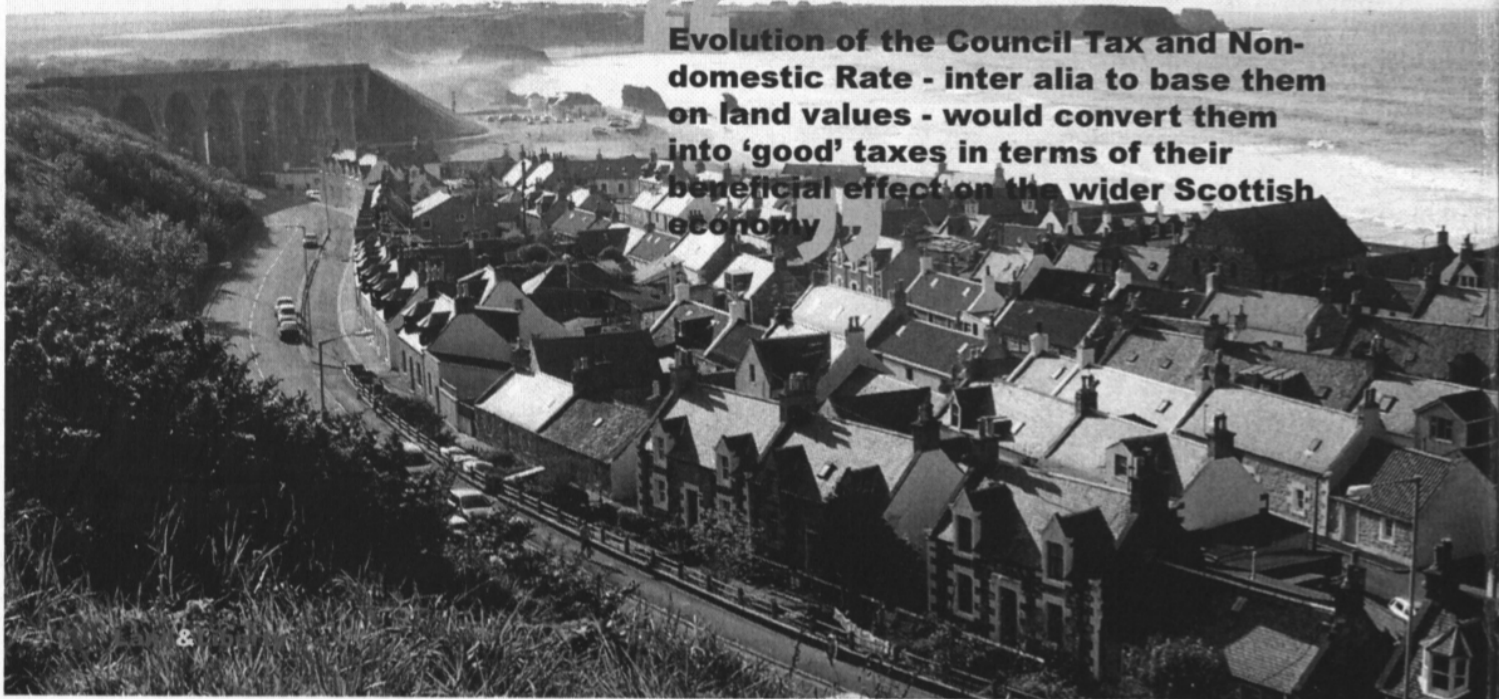
Scotland's fiscal contribution to Exchequer revenue is £31.4bn. It would not be correct to claim that 30% of this sum is a measure of the deadweight losses suffered by Scotland (£9.4bn). The total includes revenue from Council Tax and Non-Domestic Rates (£3.16bn). Some of this revenue is derived from the site-value of residential and commercial property. This sum, therefore, needs to be deducted from the contribution to the exchequer, to estimate the total loss of wealth and welfare. We also need to exclude revenue raised by local

The opportunity cost to the Scottish economy of failing to evolve our system of public finance is massive and ongoing

welfare is the 'Social Opportunity Cost of Exchequer Funds' (SOCEF). The measure of SOCEF which the Treasury uses is thirty pence in the pound. In other words, in the Treasury's own opinion and calculations, for every pound which it raises through a 'bad' tax, there is a loss of wealth and welfare to the wider economy of thirty pence that would otherwise have been enjoyed by people in Scotland.

This means, for instance, that the Scottish economy loses - every year - £2.25bn as a result of the £7.5bn raised from its citizens by means of Income Tax. Scottish people contribute £5.2bn to the national exchequer through VAT and Social Security contributions. This means there is a further loss of £1.6bn to the wealth and welfare of Scotland. Corporation and other tax revenues

Evolution of the Council Tax and Non-domestic Rate - inter alia to base them on land values - would convert them into 'good' taxes in terms of their beneficial effect on the wider Scottish economy



fresh thinking

authorities from sales, fees and charges (£1.96b), which do not entail an excess burden. Local governments also receive sums (such as from sales of fixed assets) that do not entail an excess burden.

For illustrative purposes

— and allowing for the deficiencies in the data — we assume that about £5bn raised by local government is free of excess burden. This means that Scotland contributes £26.4bn to the Exchequer by means of fiscal instruments that damage its economy. The SOCEF of this sum is £7.92bn. In other words, if all the 'bad' taxes were replaced, Scotland would be better off by about £8bn, year in, year out.

This £8bn in foregone wealth and welfare is the measure of the test that challenges the ongoing work of the Scottish Local Government Finance Review.

Can the people of Scotland afford to abandon the sum of £8bn this year — and another £8bn next year, and yet another £8bn the year after? How many additional schools and hospitals could be funded by the public sector's share of windfall gains from tax reform?

Does any alternative tax reform deliver additional benefits of this magnitude? In fact, competing proposals, such as Local Income Tax, would increase deadweight losses. By eliminating Council Tax and Non-domestic Rates, the direct charge on site values would be diminished; so the excess burden again would be increased.

The empirical evidence leaves no doubt that site-value-based revenue is feasible at both the local or national levels. For an insight into how one state administration employs site-value tax, we recommend a visit to the New South Wales Valuer-General's website www.lands.nsw.gov.au. This Australian state's Land Tax (instituted in 1917) is fully explained on-line. Property owners can access a page that provides a land tax calculator and the downloadable *Land Tax Information Booklet*, which gives a full account of how valuations are made, how to lodge appeals against a valuation, and so on.

The practical nature of the 'Rent-as-Public-Revenue' policy cannot be seriously challenged. Should anyone

wish to take evidence from a European Union member that has employed Land Tax for eighty years, we recommend a

“Such an evolution of the current system is the only policy option before the Review which delivers the economic growth sought by its terms of reference”

research trip to Copenhagen. There it will be discovered that appeals against land valuations for tax purposes are well below those directed at the Council Tax or its predecessor in the UK, the rating system. (We cite these examples not because we recommend the tax rates being used — which are inappropriately low, thereby depriving people of the potential social and economic benefits — but to demonstrate empirically the practicality of site-values-only as a revenue base.)

For our illustrative calculations, we have used the Treasury's preferred measure of SOCEF: the loss of thirty pence-worth of wealth and welfare for every £ raised

by taxes that distort economic activity. However many distinguished economists report, in their academic literature, that the deadweight losses exceed such a measure by a considerable factor. One US professor of economics, Nicolaus Tideman, has specialised in measuring the impact of the shift from the 'bad' taxes to revenue derived from land rents. In his judgement, the loss of wealth and welfare is in fact closer to £2 for every £1 raised by harmful taxes.

The true scale of the fiscal damage inflicted on Scotland by its present systems of local and national taxation is actually considerably higher than the estimates that we have suggested above. Those charged with reviewing the present arrangements for paying for local public services and infrastructure may wish to take this matter into account when it formulates its recommendations to the Scottish Executive. **L&L**

“Evolution of the Council Tax and Non-domestic Rates is the policy option which would deliver optimal long-term political acceptability and public support”

