



Nothing to Lose But Your Chains

Reforming the English Local Government Finance System

Tony Travers and **Lorena Esposito**

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Reforming the English Local Government
Finance System

by Tony Travers
and Lorena Esposito

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1. Introduction

Any analysis of local government funding addresses an issue of significant importance to the United Kingdom's unwritten constitution. The financial autonomy of regional and local authorities in England will directly influence the extent to which such institutions can choose to use their legitimate – and directly-elected – discretion to make decisions that may differ from decisions that would otherwise be imposed from the centre. Although there is some debate about the precise extent to which the proportion of income raised locally will influence local discretion, it would be surprising if there were no such link.

In theory, there need not be a link between financial autonomy and local discretion, but in practice there clearly is one. However, any move to provide local government with a larger share of UK taxation would certainly require a concession of power by the Treasury. In 2004-05, local taxation represents just 4.3% of overall government receipts. The Treasury is responsible for the remaining 95.7%. Thus, a decision to increase the locally-funded share of local authority revenue expenditure from the 2004-05 level of 26% to, say,

75% would require the extent of the Treasury's grip on the UK tax system to decline from 95% to about 85%.

Very few developed democracies raise such a large proportion of total taxation at the national level. The implications for constitutional pluralism are profound. Checks and balances within the constitution will have been weakened. It is hard to imagine a revival of local government's constitutional role, unless there is a clear decision to align local revenue-raising more closely to local service responsibilities within a system where local government is responsible for a significant proportion of public service provision.

However, it would be naïve to ignore the fact that the British electorate, as represented by Members of Parliament, regional governments and local authorities, generates powerful demands for the fair treatment of individual areas within the country. The balance of public expenditure between different parts of the UK or between Scotland and the North West of England is a regular feature of political debate. Formula Spending Shares (FSS) are a way of measuring spending needs as part of the local government finance system. As this report will observe, by international standards FSS is relatively complex, with separate assessments for several individual services. Central government provides grant to equalise between authorities on the basis of these needs assessments and also to even out differences in local tax bases. Much political pressure is devoted to making the allocation of public spending "fairer" in this way.

Successive governments have also evolved expectations that local government should provide services equally to individuals in different authorities without taking account of their particular needs. In recent years, the idea of achieving equivalent service outputs or outcomes has gained ground. Thus, for example,

children from very different backgrounds attend schools which are expected to educate them in such a way that they achieve broadly equivalent outcomes, regardless of parental income or circumstances.

However, the national tax and benefit system in the UK continues to tolerate significant levels of personal income inequality. Often these differentials are rather greater than those seen in other developed (particularly European) countries. Yet, despite the wide levels of differences between the circumstances of particular households and individuals, public services are expected to achieve the levels of equity and equality outlined above.

Equalisation grants are part of the means by which central government seeks to assist individual local authorities cope with the extraordinary requirement that provision such as schools, personal social services, policing and libraries should achieve equal outcomes with individuals who the tax and benefit system have left in very different circumstances.

Given the scale of these demands placed on local welfare services, it is small wonder there is such concern about the calculation and allocation of FSS. It is also unsurprising that central government feels the need to act as public service regulator and guarantor. However, within such a system, there will be reduced freedom for local action. Public expectations that central government will be involved in the avoidance of “postcode lotteries”, coupled with the massive demands placed upon local government to achieve equal outcomes, leave little room for local discretion.

A system of local government funding that radically altered the balance of funding between the centre and local government might lead to significant differences in the level of services from one place

to another. A so-called “postcode lottery” might be the price that has – in part – to be paid for greater local autonomy. The degree of equalisation within any changed local funding system would be important in determining how much differentiation might emerge. But it is also possible that greater local freedom might lead to competition to improve. Standards might chase each other upwards as civic leadership re-asserted itself.

This report analyses the existing financial autonomy of local government with a view to making proposals for reform. It is important to note that any change to the existing system of council funding would be likely to lead to some authorities and/or individuals being made better, or worse, off. A substantial move towards more locally-determined local tax-raising would mean that, over time, there could be changes in the amounts paid by taxpayers. Such changes would be a welcome sign that real local autonomy had been achieved.

Of course, it would be possible to operate on the basis of an explicit (or, more likely, implicit) assumption that no local tax burden – for authorities or individuals – should ever change by more than a tiny percentage. Today’s governments and politicians fear the unpopularity that might accompany reform. It is certainly important to be aware of the possibility that a redistribution of the highly-visible local tax burden could lead to public revolt. In recognition of this reality, the proposals in this report would allow any local authority to leave its local taxation position exactly as it is today. A decision to adopt one or more of the radical options proposed would be made locally, in the light of local consultation and/or a referendum.

As decisions about local taxation reform are left to local authorities themselves, there can be no precise quantification of any

particular proposed reform. An authority that wished to re-localise the non-domestic rate or to start using a local income tax would certainly have to look at the consequences for administrative costs and for the local shift of burden. No council could proceed unless it had undertaken a detailed analysis of how the new arrangements would work. Such calculations would, appropriately, be undertaken at the local level.

Of course, equalisation would have to continue. Local government in this country has evolved in such a way that there are widespread assumptions that poor individuals and households should not be disadvantaged when it comes to local services and taxation. There would need to be transitional arrangements where an authority or authorities chose to move off into a more devolved arrangement for tax-raising. However, one of the lessons of recent years is that ODPM officials are capable of designing grant systems of limitless sophistication and cleverness.

The purpose of the full report is to stimulate a further debate about the possibility of transforming British local government from its present weakened state into something more autonomous and more genuinely local. It is possible, on reading the analysis and proposals, that politicians (and possibly local residents) will take the view that change would be just too difficult. Perhaps the British really want to live in a country where virtually all decisions about every public service are made in Whitehall and are then subject to central oversight to ensure uniformity.

It is worth observing that the move in recent years – under both Labour and Conservative governments – towards greater central funding and direction of public service has not eradicated the “postcode lottery”. Far from it. An alternative formulation would be

to allow local government to de-couple itself from the leaden control of the centre and to become more locally-responsive and competitive. Greater autonomy over funding would surely be the first step towards such liberation.

2. Summary:

Proposed Reforms to England's System of Local Government Finance

In designing a set of reforms for the system of local government finance in England, we have been guided by the “Ten Principles of a Good Local Finance System” which we published earlier in 2004 (reproduced in Appendix 1).

The reforms we recommend aim to correct some of the shortcomings of the present system of local finance, but also reflect current political realities. We believe they provide a solution that is both radical and politically feasible, returning autonomy to local government whilst retaining a workable balance between concerns about national equity and local control.

The following section provides an outline of the proposed reforms, which are then examined in individual detail in the subsequent chapters of the report.

Revenue Finance

The new system of local government finance we propose involves a core block of three mandatory local taxes (the Core Taxes), and an additional set of pre-approved discretionary local taxes, (the Discretionary Local Taxes List).

(i) The three Core Taxes

The three Core Taxes will comprise:

- A reformed Council Tax
- A relocalised Business Rate
- A Locally Variable Income Tax (within a fixed percentage band)

The Core Taxes would be mandatory in the sense that local authorities will have to set rates for them and account for their use to local voters.

The Core Taxes provide a strong base for local authorities to exert control over their local finances. The three taxes have been chosen to provide a balance of characteristics which together will provide a stable foundation for generating local income. The Council Tax and relocalised Business Rate both have their base in property, and although Council Tax is regressive in nature, they have a stable predictable yield and are easy to administer and collect. The regressive nature of the property taxes is balanced by the third Core Tax in the form of a Locally Variable Income Tax (LVIT). LVIT will increase the progressiveness and fairness of the local tax bundle, and provide local government with a buoyant source of income (ie a tax whose yield rises automatically in line with a growth in the tax base). The

uncertain nature of the yield of LVIT is significantly countered by the predictability of the property taxes.

Similar proposals to allow local authorities to have the use of a combination of local taxes were made by the LGA [LGA, 2004c] in a submission to the Balance of Funding review.

(ii) The Discretionary Local Taxes List

To supplement the income generated by the Core Taxes there will also be available to local authorities a pre-approved list of discretionary local taxes from which they will be able to pick and chose (or indeed not use) to raise further revenues. Local authorities may also choose to introduce one or more discretionary taxes to reduce/vary the proportion of local income that comes from the Core Taxes.

The Discretionary Taxes List aims to re-empower local authorities, giving them back the ability to respond to features of the local tax base and greater control over revenue generation.

The operation of the Discretionary Local Taxes List is analysed in more detail in Chapter 6.

(iii) Charges for Services

Our proposals build on the already available powers for local authorities to charge for locally provided services. Under the reformed system, local authorities will have the power to charge for any of the discretionary services that they provide.

More detail on the increased charging powers can be found in Chapter 7.

(iv) Specific Grant Financing

The use of specific grant financing in the proposed system will

become the exception rather than the norm. The overall aim is not to reduce or remove the services currently financed by specific funding, but simply to finance them through the general equalisation grant or locally generated income. Local authorities will still provide the range of services provided currently, but will be free to allocate the funding themselves.

The role of specific grants is analysed further in Chapter 8.

(v) Equalisation and the Grant System

The calculation of equalisation grants under our proposals will still take account of differences in local resource base for the three Core Taxes. The proposal is for a similar system of point equalisation (ie, equalisation up to the level of the local spending assessment for each authority) to that currently in operation with a vertical transfer of grants from central to local government. We also propose greatly to simplify the process of needs equalisation, both by reducing the number of needs indicators and by handing calculation of spending assessments to an independent body. The new spending assessments will not be based on service blocks but will encapsulate an overall measure of spending needs.

All equalisation grants will go into general non-ringfenced funding, and central government will no longer be able to require local authorities to use parts of the year-on-year grant increases for spending on specific services – ie passporting will be abolished.

A detailed review of the equalisation system and its workings can be found in Chapter 9.

Our reforms: A flexible, locally autonomous system of local finance

The package of reforms proposed, despite its radical nature, is also exceptionally flexible and ultimately politically feasible. It would allow local councils to structure their finances in a way which best suits their locality and local tax base, and is so flexible as to allow individual councils, if they wish, to effectively maintain the status quo. For example, a council could choose to maintain the (largely unchanged) Council Tax, set a Business Rate multiplier linked to inflation, and set LVIT at the tax neutral rate. Such a council would still receive a full equalisation grant and be able to apply for specific financing if necessary. Alternatively, it would also be possible for a council with a more varied approach to finance to have an entirely different financial system within the same reform framework, ie, maintaining the Council Tax, with a non-inflation linked Business Rate multiplier, a high level of LVIT and one, or several of the discretionary taxes.

Appendix 2 sets out three possible examples of how individual authorities may choose to structure their finances, showing the adaptability of the system to local circumstances, and the variations that can be achieved.

Politically the recommended reforms also have several distinct advantages over previous changes to the local finance system (such as the Poll Tax) and other proposed reforms (such as the scrapping of the Council Tax):

- *No new taxes without a local referendum*
Council Tax remains, the Business Rate remains and is simply relocalised, LVIT is a reassignment of national income tax to the

local level, and some discretionary taxes (eg congestion charges) already exist

- *There is no new onerous administration*

Both the Council Tax and Business Rate will use systems already in place, and LVIT will rely on national PAYE systems with an increased role for the Inland Revenue. Any administration associated with the introduction of a discretionary tax is a choice made by individual local authorities rather than a central decision

- *Full point equalisation is still achieved*

Local authorities will still receive general grants which fully equalise for resources and spending needs up to the level of the local spending assessment

- *There is no immediate redistribution between local taxpayers*

The introduction of the reforms does not cause any immediate onerous redistribution between classes of local taxpayers, and as such will not mean large unpopular rises in any of the taxes suggested.

In year one of introduction, there will effectively be no change from the current system as local authorities start to design and construct individual local finance systems which best suit them within the remit of the overall reform package.

Changes will begin to take place from year two onwards as councils initiate changes in the balance of their local funding and introduce/vary the taxes at their disposal.

3. Detailed Analysis of Reforms, 1: Council Tax

The first of our proposed three Core Taxes is a reformed Council Tax. This chapter analyses the shortcomings of the current Council Tax system, and the rationale for retaining an element of property taxation in the Core Taxes bundle.

The problem with Council Tax

The current system of local government finance in England has only one locally determined tax: the Council Tax. As discussed in our previous publication [Travers and Esposito, 2004, p 19-24], the operation of Council Tax within today's centrally biased-system of funding is rife with shortcomings. These include:

- Its contribution to the gearing effect (which is caused by the small proportion of Council Tax relative to central grants in local income) and the resultant blurring of local accountability,

- Its regressive nature (households in lower Council Tax bands tend to pay a much larger proportion of their income in Council Tax than those households in higher bands), and hence its unpopularity with the general public,
- Its lack of buoyancy,
- Its highly visible nature,
- Its load-bearing weakness; (ie because the property base in England is static, and not well related to income, Council Tax is incapable of yielding very much more tax revenue than it does at present), and
- Central control over major aspects of Council Tax; most importantly the ability of central governments to cap Council Tax rises, but also central control over valuations, valuation periods, bandings, and band-to-band ratios.

The major shortcoming of the Council Tax is the so called ‘gearing effect’ which is caused by its low percentage contribution to the overall revenue of local government. Council Tax is the only means available to local authorities to meet any shortfall in funding between their budgetary requirements and central support allocations. Councils which want to expand their budgets are therefore forced to raise Council Tax bills, and only those who cut spending or get more central grant than they need can afford to cut Council Tax bills (on average a 1% change in spending in English local authorities, will lead to a 4% change in Council Tax).

The gearing effect exacerbates many of the other shortcomings of Council Tax. If the gearing effect could be removed, it could be argued that visibility and non-buoyancy are positive attributes of the Council Tax. Highly visible taxes which must be directly altered annually to

meet budgets, force tax-setters to be directly and clearly accountable for tax rises and avoid taxing by stealth.' [Travers and Esposito, 2004, p22]

The rationale for retaining Council Tax within a reformed system

Despite these shortcomings, Council Tax, and property taxes in general, are a good means of local taxation. Property taxes by their very nature are easy to collect and administer ('buildings don't move'), and property provides a secure asset base upon which to base a form of local taxation. Property taxes are difficult to evade and as a result collection rates are high (Council Tax collection rates nationally were 96.1% in 2001-02. [ODPM, 2003, Local Government Financial Statistics, England, No13, p 43]). In addition, the current system of Council Tax, and its structure, is well understood by the majority of voters. However, the benefits of a well-designed property tax are overshadowed in the current local finance regime by the many weaknesses of Council Tax.

The strengths of a property tax should not be underestimated, and a tax of this sort should always form part of the basket of local taxes available to local government. Internationally it is the most commonly levied type of local tax, with every European country (except Sweden) having a form of local property tax. Within our new basket of taxes, we propose that a reformed Council Tax should be one of the three mandatory 'core' local taxes (along with a relocalised Business Rate, and a Locally Variable Income Tax), that when combined will make up the majority of local income. The weight borne by the Council Tax within this mix of 'core' taxes will be at the discretion of each local authority.

We are therefore recommending the retention of Council Tax (with some important changes – see below) as a local tax. Reducing the pressure on Council Tax by making it part of a bundle of local taxes rather than a single local tax would immediately alleviate many of its current shortcomings.

How should Council Tax be reformed in the new system?

We believe some changes do need to be made to the present Council Tax system in order for its current weaknesses to be properly addressed.

(i) Capping of budgets, and local taxes, must be abolished in any form. In 2004-05, the Labour government invoked its selective capping powers for the first time since the enactment of the Local Government (Best Value and Capping) Act, 1999. Seven councils were identified for capping in 2004-05, with a further seven targeted for capping in 2005-06.

Capping Announcement - 29 April 2004

In a statement to the House of Commons on 29 April, Nick Raynsford announced that seven authorities had been identified for budget capping this year.

He also announced that the Government proposed using its capping powers to ensure next year's spending would not be excessive for a further seven authorities.

Any notion of capping in a local finance system is an affront to local freedoms and completely negates any notion of local democracy and accountability. The threat of capping is just another feature of a centrally-dictated local finance system which, rather than protecting local people from excessive tax rises, actually limits local choices and puts increasing strain on local service provision, thereby distorting local sector choices and adaptability. ‘These powers have normally been described as powers to cap local authorities, but in reality they are powers to limit the choices open to local people. Local people cannot then decide through local elections that expenditure on local services should be increased, even if they are willing to pay the taxation involved...Capping distorts the electoral process, limiting choice on budgetary policy.’ [Stewart, 2003, p231 and 232].

We would strongly recommend that capping in any form, against budgets or specific taxes, is abolished.

(ii) Revaluations of property for Council Tax must be timetabled by legislation

Current property value bandings, and the valuations themselves, have not been reviewed since the Council Tax was introduced in England in 1993, with valuations based on 1 April 1991 values. A review of valuations and bandings has been scheduled for 2007 – a gap of nearly 14 years. (The Local Government Act 2003 provides for new property valuations to come into force on 1 April 2007, based on 2005 valuations, with ten yearly valuations thereafter).

Under the current system, all revaluations are undertaken by the Valuation Office of the Inland Revenue at the instruction of central government. There is no legislative timetable to set revaluations or review bandings.

Valuations, therefore, are currently a facet of the Council Tax system entirely under the control of central government. Local authorities have no control over this aspect of the tax, and cannot benefit from rising property values, nor adjust valuations downwards during property slumps. Moreover, central government can decide not to revalue properties for political reasons (as happened repeatedly under the old rating system).

We are in favour of a central body, such as the Valuation Office, carrying out revaluations, as there is a danger that if given the power to revalue locally, local authorities would distort their local valuations in order to manipulate both their Council Tax bills and equalisation grants. However, to increase stability, and to allow local property tax to reflect local property values, revaluations should be regularly timetabled, say once every five years, in statute. Given the rapid changes in British property prices, the proposed ten yearly valuations in the Local Government Act 2003 are, in our opinion, at too long an interval. Formalising the valuation procedure will prevent revaluations being cancelled or postponed for political reasons, and allow local authorities/local people to benefit from changing market valuations without having to wait for central government to decide to act.

(iii) Council Tax reform in the future?

Reviewing the current bandings and band-to-band ratios.

Our chief concern has been to resolve the gearing and non-buoyancy problems associated with the current system of local finance due to its reliance on the Council Tax.

As discussed above, the current valuation bandings, national property valuations, and band-to-band ratios have not been

adjusted or reviewed since the Council Tax came into operation. Consequently the current structure upon which Council Tax is based does not necessarily reflect the state of the property market in England, nor how it has changed since the system was designed and the initial valuations took place. A detailed review carried out by the New Policy Institute [2004] makes it clear that it is necessary to reform the Council Tax bandings, and the band-to-band ratios, if the overall structure of Council Tax is to come up-to-date and become more progressive.

Our main recommendations are that Council Tax, as a form of property tax which is well understood with familiar administration systems, remains as a part of the basket of taxes available to local government, and that capping of Council Tax budgets is abolished. This, alongside the use of the other core taxes and the rest of our proposed reforms, would greatly reduce the buoyancy and gearing problems of the current system, and the overall progressiveness of the local tax system would be improved.

We recognise that it is likely that Council Tax will need to be reformed further, but are not recommending any other significant changes in the initial stages. Our package of reforms addresses the most pressing problems linked to the current system, and any future reform to the detailed workings of Council Tax will need to be based on how it works within the new overall regime of local government finance proposed in this report.

Conclusions

The retention of Council Tax as one of the three core local taxes in our reformed local finance system is based on the strengths of

property tax as a form of local taxation. Some reforms to the present structure of Council Tax are necessary to resolve its current shortcomings (in particular the abolition of capping), but in the main, easing the strain on Council Tax will be achieved by increasing the proportion of local council expenditure borne by other locally raised taxes. In particular, the gearing effect and its negative effect on local accountability will cease to be of such importance as local authorities will be able to raise the majority of their income from locally determined sources.

4. Detailed Analysis of Reforms, 2: Relocalised Business Rate

The second proposed Core Tax is a relocalised Business Rate. This chapter examines the shortcomings of the current centralised system before analysing the benefits associated with a local system of Business Rate taxation. The specific features of the proposed relocalised system are then put forward alongside some ideas for equalisation.

Current Issues with NNDR

The National Non-Domestic Business Rate (NNDR) is not a local tax – it was removed from local control in 1990 and since then has been distributed to local authorities as part of the annual finance settlement. There is no local autonomy in the setting of NNDR: valuations of business property and the setting of the NNDR multiplier are entirely central decisions. Local government acts as the

NNDR collection agent of central government, and the level of NNDR individual authorities receive is not related to their business tax base, but rather their population.

This lack of local control over Business Rates has led to a complete breakdown in the links between local businesses and local authorities. The actual amount of NNDR distributed back to local authorities bears little relation to the actual sums of NNDR that local businesses pay. This mismatch reduces local authorities' accountability to local businesses. Businesses cannot pick and choose between local authorities on the basis of NNDR, nor (excepting the Local Authority Business Growth Incentives which will allow local authorities to keep a proportion of increases in Business Rate income from 2005) is there any real incentive for local authorities encourage new business into their area.

Under the present regime, businesses are protected from local tax rises at the expense of Council Tax payers; increases in the NNDR multiplier (the poundage set by central government which is applied to the rateable value of businesses to calculate NNDR) are capped at the Retail Prices Index (RPI), whereas Council Tax bills have no such protection; 'Council Tax has risen by 37.5% in real terms since 1993/94, whilst the equivalent increase in NNDR has only been 5.4% in real terms.' [LGA, 2004a, p 2].

The benefits of relocating the Business Rate

(i) Most authorities will be able to raise at least 50% of their income locally

Relocating the Business Rate immediately solves the balance of funding crisis currently affecting local government finance.

Returning the Business Rate to local control will put the majority of local authorities in a position where they will be raising approximately 50% of their revenues themselves, ‘Nationally, the effect of localisation would be to raise the amount of locally-raised funding from around 26% to around 48%.’ [CBI, 2004, p5] Pressure on Council Tax and the problem of gearing will both be relieved.

(ii) There are no, or few, added administration costs in relocalising the current NNDR

There is no burdensome administrative cost in relocalising the Business Rate since the systems for collecting NNDR are already in place at local authority level. The only change would entail local authorities setting their own Business Rate multiplier and applying this to the properties in their area.

We suggest that the valuation of business property should remain under the authority of a central body, such as the Valuation Office. This would prevent local authorities from distorting local property values so to increase the putative value of their tax base. Business property is currently revalued at five yearly intervals, and this timetabling of revaluations should be enshrined in statute, to avoid the situation under the previous local Business Rate system where ‘...there was no revaluation for 17 years.’ [CBI, 2004, p 7]

(iii) Improved local accountability through links with local business
Relocalising the Business Rate would improve local accountability by re-establishing a direct financial link between local businesses and local authorities. It is almost inevitable that local businesses will become more aware of the provision and quality of local services if their Business Rate is locally variable. This will have a knock-on

effect on local authorities, who will have fully to justify Business Rate increases (relative to increases in other local taxes), and may also have the added benefit of encouraging local businesses to become more involved in their localities and take a more active role in assessing and requesting better services. ‘Local authorities would need to take into account the views and needs of local businesses in a far more meaningful way, when deciding upon service priorities, the budget and tax levels.’ [LGA, 2004a, p6]

There is an argument that NNDR should not be returned to local control as it is ‘taxation without representation’ (ie, there is no direct link between business taxation and local voting power). It is true that many business owners will live in a different local authority area to that in which they operate their business, and therefore have no direct local vote. However this same argument could be applied to corporation tax, and does not provide a valid justification for not returning control of Business Rates to local government. Businesses have a strong lobbying presence and can influence local decisions without the need for a direct vote. Business groups such as the Confederation of Business Industry (CBI) lobby central and local government on behalf of their members continually – to say local businesses have no voice is a vast understatement. Local businesses are as much consumers of local services as residents, and should make a direct contribution to (and maintain an interest in) local service provision.

(iv) Local authorities will be able to use Business Rate competition to increase their local tax bases

A well-designed local Business Rate system would also have the added benefit of allowing local authorities to compete in order to

attract and retain businesses in their area. For this to be so, local authorities must be allowed to retain the benefits of any growth in the local business tax base for a number of years (ie growth should not be immediately equalised away thus removing the incentive for local authorities to encourage that growth). These issues will be discussed further below.

The features of a local Business Rate system

As discussed above, the return of the Business Rates to local control would not require the implementation of major new collection/administration systems as the collection and billing systems already in place for NNDR will serve a localised rate as at present. The localised Business Rate would remain on the same basis ie rateable value, as the current NNDR. We would also expect valuations to continue to be carried out by the Valuation Office on a regular five-yearly basis, and that the revaluation timetable be written into legislation to ensure valuations are regular, accurate, and to prevent the timetable being manipulated by central government for political reasons.

There are several other features we would like to see built into a local Business Rate system both to make the tax more predictable and stable for local businesses, but also to give local authorities greater control over their business tax base.

(i) RPI capping for local Business Rate multipliers should be abolished

The CBI argues that the RPI cap ‘...gives business vital protection against unaffordable rate increases and eases planning over the short

and long term.’ [CBI, 2004, p1]. However, an inflation-linked cap on Business Rate multipliers effectively limits the control of local authorities over their local tax base, and the protection and stability afforded to local business has been at the expense of domestic Council Tax payers who have no such security over the levels of their bills. ‘...Relocalisation actually presents the opportunity to re-establish the link between NDR and Council Tax, ensuring that marginal increases or decreases in expenditure impact upon both NDR and Council Tax payers.’ [LGA, 2004a, p4].

(ii) Increases in local Business Rates should be limited by increases in Council Tax rates

In order to offer some stability to local businesses, and to assuage fears that local authorities will switch local costs from ‘voting’ Council Tax payers on to non-voting businesses, local Business Rate rises should not be allowed to exceed Council Tax rises in any year. This feature of the local Business Rate system should be written into legislation to prevent local authorities disproportionately raising Business Rates. Of course, within this upper boundary local authorities can choose the extent to which individual taxes within the core taxes element (comprising the reformed Council Tax, the relocalised Business Rate, and a locally variable income tax) contribute to local income, and can vary the emphasis to suit local conditions.

(iii) Local authorities should have the power to introduce exemptions, thresholds and rates for different classes of business. Within the overall framework for local business taxes, local authorities should have the power to introduce and vary exemptions, thresholds and Business Rate multipliers as they see fit.

This would include, for example, the recognition that Business Rates are comparatively regressive for small businesses and business start ups. As such local authorities should be allowed to introduce exemptions/discounts for small businesses (with rateable values below a certain level) or for start ups.

Local authorities should also be able to introduce local exemptions based on their business tax base and local industry structure, both to encourage specific businesses to invest in the local area, or to assist in easing downturns in specific industries. Some of these exemptions could be temporary, and some could form permanent features of the local tax system, but they will be based on what local authorities believe best suits their area and tax base. This increased discretion will allow local authorities to compete for business location and retention on the basis Business Rates.

It is likely that these reliefs and exemptions will be set with direct reference to (and in consultation with) local business. This will allow local authorities to be more responsive in adapting and reacting to the needs of their business communities, whilst also allowing local business a forum for local debate and better appreciation for their vital role in raising local revenues. ‘...The greater the discretion that local government has about the level of NDR and the reliefs it can grant to the business community, the more responsive local authorities can be to the needs of their business communities.’ [LGA, 2004a, p10]

The effects of policies such as these on local business location/retention are untested, and will need to be monitored to ensure that authorities with low Non-Domestic Rate bases are able to take advantage of new competitive mechanisms for attracting additional businesses.

(iv) Increases in Business Rate revenue due to a growth in the Business Rate base should be retained locally for three years. As previously discussed, this feature of the localised Business Rate system is necessary to provide local authorities with the incentives to develop policies to attract and retain businesses in their area. If gains in Business Rate base are not able to be retained for any period, ie they are 'lost' in the equalisation process, local authorities will have no incentive to attract business, and inter-authority competition on the basis of Business Rate multipliers would be meaningless.

We would suggest that the benefit of any growth in the Business Rate base be retained in the local authority for three years after it is achieved. This would be accomplished by not accounting for the increase in the tax base when calculating equalisation grants (up to the level of the local spending assessment), until three years after the initial growth is achieved. However, it is worth noting that should the Business Rate base in a local authority fall, there would still be full equalisation up to the point of the local spending assessment. This is discussed further in the following section.

Equalisation: differing local Business Rate bases and the possibility of regional equalisation pools

A full discussion of equalisation, and the calculation of general grants, under our proposed reforms is laid out in Chapter 9. However, the wide variations in Business Rate tax bases across England means that equalisation for a relocalised business tax merits some further discussion.

Differing Business Rate bases and the problem of equalisation
Business Rate bases across local authorities vary greatly. ‘Westminster City Council alone raises nearly 6% of the total locally-collected Business Rate pool, substantially more than Liverpool, Manchester, Birmingham, and Newcastle combined.’ [CBI, 2004, p6]. There must, therefore, be some degree of equalisation to account for the differences in local tax bases and the differences in ability to raise local Business Rates across the country.

Partial equalisation for local Business Rates

The current system offers full equalisation for NNDR with each authority receiving the same amount of redistributed NNDR per head of population. In Chapter 9 we discuss feasible reforms to this system, taking into account our proposed new core system of local taxes. Under this system, equalisation - and therefore the calculation of central grant support - would be based on a (simplified) calculation of spending need for each local authority, from which assumed levels of Council Tax, Business Rate and Locally Variable Income Tax would be deducted to arrive at the level of general central grant.

The proposed system allows for equalisation up to the point of the local spending assessment; any Business Rate revenue raised above the level of the local spending assessment would be retained by the individual local authority. High rate base authorities are therefore favoured for spending above these levels, and as such there needs to be a method by which this excess Business Rate in certain authorities can be skimmed off and redistributed, either nationally or regionally (see below).

When combined with the measures for local authorities to retain the benefits of increased growth in their business tax rate base for

several years, the new equalisation system maintains partial equalisation up to the point of the local spending assessment, whilst still providing incentives for local authorities to increase their local Business Rate base.

Regional Business Rate equalisation pools: London authorities.

It is possible, under the system of point equalisation described, for high Business Rate base authorities to receive negative central grant assessments if their assumed local tax revenue exceeds their central spending assessment. These authorities are likely to be the current net contributors to the NNDR pool, ie, London based, and to solve this disparity an additional layer of equalisation could be added.

This additional layer could take the form of a regional Non-Domestic Rate equalisation pool for London authorities, similar to the scheme that operated in London under the old rating system. The pool would be a self-financing method of redistributing gains from high Business Rate base authorities in London, to those with low Business Rate bases. It is hoped that a regional system such as this would create regional business solidarity in the area, with the contributions from high resource base authorities seen as transfers to boost the economy of the region as a whole, thus improving business opportunities for all and creating an environment for growth.

The design of the regional pooling method needs some consideration, and several issues would need to be resolved in this process;

- How will it be decided which authorities make payments to the pool? There could be an annual comparison of average Business Rateable value per head across the London boroughs, with above

average boroughs making a contribution to the pool, and below average boroughs receiving a payment.

- What would payments into the pool consist of? These could be the value of the negative central grant assessments to those authorities which receive them, or more likely, contributions could be based on a contribution poundage applied to the Business Rateable value in each authority.
- If used, how would the contribution poundage be set? And by whom?
- How will the monies in the pool be distributed? A possibility could be to distribute the pool to below average Business Rate base boroughs in relation to the proportional value of their per capita Business Rate base when compared to other boroughs in the region.

A London based regional pool has been suggested because many of the current net contributors to the NNDR pool are London authorities. However, there is no reason to prevent regional Business Rate equalisation pools being established in other areas of the country, hence creating the anticipated local business solidarity and local business participation, if the London scheme proves successful.

Conclusions

The relocalisation of the Business Rate is an important element of our reform package, and will form one of the three core local taxes available to local government to raise local revenue. With the current collection and billing systems already in place for NNDR, relocalisation is a straightforward and low cost way to ensure the majority of

local authorities are raising a minimum of half of their revenues from locally determined sources, thus increasing local autonomy. A locally controlled Business Rate will also re-establish links between local businesses and local councils, giving local businesses the incentive to become more interested and involved in the levels and quality of local service provision, whilst at the same time providing an additional check on local authority performance.

It is important that there are safeguards put in place to ensure the localised system reaps the benefits envisaged, and to provide some reassurance to local businesses. These should include; consistent timetabled and independent revaluations, exemptions and discounts for small businesses and start-ups, and an equalisation system that accounts for differing resource bases (up to a defined point) without removing the incentives to local authorities to increase local tax bases.

The arguments against the relocation of the Business Rate emanate mainly from business groups, and relate to the potential damage to business and the disparities in tax bases. However, these arguments are often a reaction to a blanket relocation of the Business Rate as an accounting measure to resolve the local/central balance of funding crisis. As part of an overall package of local finance reform, and with the safeguards noted above put in place, the relocation of the Business Rate is a strong and simple tool to increase local freedom and accountability without alienating local businesses. Its place in a package of locally controlled taxes cannot be ignored.

5. Detailed Analysis of Reforms, 3: Locally Variable Income Tax

The final element of the Core Taxes system involves the replacement of a portion of national income tax with a Locally Variable Income Tax (LVIT). This chapter lays out the arguments for LVIT and outlines the framework within which the tax would work.

It is important to note that the detailed design of the technical workings of an LVIT system is outside the scope of this report. We are aware of the issues and potential problems of designing and implementing LVIT and review these at the end of the chapter, however we do not believe that they negate the advantages of LVIT and that they can be resolved in the design of the system which we propose.

The rationale for introducing a Locally Variable Income Tax

The idea of introducing an element of Income Tax into the local

finance system is not new. The Layfield Committee review of Local Government Finance in 1976 was of the view that, ‘A local tax on all personal incomes, the rate being set by the local authorities, is the only feasible major new source of income meriting further investigation...introducing LVIT is a necessary condition of greater local responsibility...’ [Layfield Committee Report, 1976, p209 and p298].

Moreover LVIT is a feature of local finance systems the world over. Germany, Spain and the USA, all have elements of LVIT within their local tax regimes, and Sweden (alongside other Nordic countries) has a highly effective and well regarded local income tax as the sole tax at the heart of its local government finance system. Despite the success of Swedish municipalities in raising local income, we would not advocate the reliance of a local finance system on any single type of taxation. However the introduction of a system of LVIT in conjunction with other Core Taxes is an effective way of increasing the autonomy and accountability of local government.

(i) Strengths of LVIT as a Core Tax

LVIT has many strengths, which when combined with the other two Core Taxes will provide local government with a diverse and more progressive basket of local taxes.

- *Buoyancy*

LVIT is a buoyant tax (ie its yield increases as the tax base grows) giving local authorities a source of local revenue which automatically adjusts to changes in the local tax base without the requirement for a direct annual intervention from local govern-

ment to adjust the tax rate. LVIT as one of the Core Taxes thus complements the non-buoyant Council Tax and Business Rate, and gives local authorities some of the same stability enjoyed by national taxation systems.

- *Progressiveness*

LVIT also improves the overall progressiveness of the bundle of Core Taxes from which local government will raise the majority of its revenue. LVIT is directly linked to ability to pay and will help ease pressure on the less progressive Council Tax.

- *Ease of collection and administration*

The collection and operation of LVIT can, with some additional design features, largely piggy-back on the existing Pay As You Earn (PAYE) collection systems for national income tax. The Inland Revenue would oversee much of the administration of LVIT in the operation of tax codes, and the distribution of monies to local authorities.

- *Increases local autonomy*

The addition of LVIT to the Core Taxes gives local authorities more freedom to construct local taxes response to their local resource base; it allows individual councils to vary the emphasis on each of the Core Taxes on a year-on-year basis, thus deciding how much of the relative local tax burden should fall on residential property, business property, or incomes.

(ii) National income taxes already finance local expenditure

It is important to recognise that national income taxes already finance local government expenditure, via central grant financing (ie national income tax funds are redistributed to local authorities within the process of calculating central grants). The introduction of

LVIT, therefore, simply formalises this current indirect relationship between national taxation and local expenditure.

Giving local authorities control over a portion of the income tax base will give them direct control over the revenue streams generated by income taxes, as well as the ability to vary the tax rate at the margin. Overall tax-take (ie national income tax plus LVIT) from Income Tax need not necessarily increase with the introduction of LVIT, as we would require that the national rate of Income Tax would fall to recognise the portion of income raised locally. The LVIT is not a new tax but rather a reassignment of a portion of a national tax to local government.

Once the current relationship between national taxes and local spending is made clear, it becomes apparent that introducing LVIT not a hugely dramatic step; it is simply a matter of apportioning control of the tax base and is a further means for increasing the responsibility and autonomy of local government over its finances.

The design of the LVIT system

The design of the system of LVIT within our proposed reforms is based on the research by CIPFA [2004] for the Balance of Funding Review. The main features of the system would be as follows:

(i) LVIT will be part of the core system of taxes

The LVIT will form part of the Core Taxes, along with a reformed Council Tax and relocalised Business Rates. This does not mean that local authorities have to make use of LVIT, and they are free to set the rate of LVIT at zero if they wish.

As discussed above, local councils must report the rates of local taxes charged to their local taxpayers each year. Even if LVIT is set at a zero rate, local taxpayers must be informed that they are not being charged LVIT, alongside their Council Tax bill, on their annual local authority tax statement. This feature of the Core Taxes system ensures that local taxes remain transparent, allowing taxpayers to clearly identify year-on-year changes to tax rates and charges, and increasing accountability.

All income from LVIT will be non-ringfenced and available for general use.

(ii) Local authorities will be able to levy LVIT at one of a series of fixed rates

Local authorities will not be given total discretion over the rate of LVIT, but will be able to set the rate at one of a series of pre-determined LVIT rates. Defined pre-determined LVIT rates are necessary for ease of introduction and administration of the system and we recommend that they work as follows:

The introduction of LVIT should coincide with a general reduction in the basic rate of national income tax in order to reflect the rate at which income tax can be collected by local government. We would suggest that the basic rate of national income tax is reduced by 4% leaving local authorities to choose where to set their LVIT rate around the central 4% reduction within a pre-determined range (see below).

We propose that local authorities should be able to increase LVIT to a maximum rate of 6% or lower it to a minimum rate of 0%, with the availability of ½% interval points between each of these rates. This would allow local authorities to set LVIT up to four percentage

points below the national reduction, or up to two percentage points above. Inevitably, the precise details of this reform will have to be fine-tuned at the point of introduction.

For the purposes of equalisation, it would be assumed that all authorities would be raising LVIT at 4%. The new system of equalisation is discussed in more detail in Chapter 9

(iii) The Inland Revenue will have to work closely with local authorities

Our proposed LVIT will use a great many of the administration and collection procedures already in place for taxing national incomes, and as such will entail a major role for the Inland Revenue.

We suggest that employers should collect LVIT on behalf of local authorities via the PAYE system for taxing earnings. This would entail the Inland Revenue estimating local tax bases, on which local authorities would base their chosen LVIT rate, before issuing a new tax code reflecting this rate to both employers and local taxpayers. Employers would then collect the LVIT alongside national income taxes and pass this to the Inland Revenue, who would distribute the LVIT portion back to each local authority.

This increased role for the Inland Revenue will mean that local tax offices will have to develop close working relationships with the finance officers in local councils, and is also likely to mean increased costs of collection and administration for the Inland Revenue.

The costs and ongoing work involved with implementing and running the LVIT should be seen as an extension of the Inland Revenue's relationship with central government; ie, that all government is the client of the Inland Revenue and not vice versa. The Inland Revenue is obliged to implement and operate systems to

respond to changes in central tax policies, and this should be no different for tax policies relating to local government.

(iv) Notes on technical issues/practicalities of an LVIT system

As noted previously, it is not our purpose to construct a detailed system for the implementation and operation of LVIT. We wish to simply provide a framework for LVIT that could work in practice, and within which experts at the Treasury would design the actual workings and minutiae of the operating system and any transitional arrangements.

We are aware that the practicalities of introducing, and designing, a workable system of LVIT will throw up difficult issues, requiring more discussion and thought. Some are included here:

- *Estimating the local tax base*

This will need to be carried out by the Inland Revenue on an annual basis, and is likely to involve using data which is out of date.

- *Residency Issues*

There are several residency issues, the most important being establishing the local authority areas in which taxpayers reside (which may of course be different from the area in which they work) so that the correct tax code can be applied to their income and the LVIT collected distributed to the correct local authority.

- *Self-employed taxpayers*

How would LVIT due from self-employed taxpayers be collected and assessed? Under the present system of Self Assessment for income tax, self-employed taxpayers fill out annual tax returns and pay additional tax due retrospectively. It may be necessary to

require that all self-employed tax returns are returned to the Inland Revenue at an earlier date than present, so that the Inland Revenue can calculate the income tax due (both national and local) and issue a demand for payment.

- *The treatment of investment income for LVIT*

Income from investments (such as interest on savings and dividends) are also subject to income tax at the national level. For the majority of taxpayers, basic rate national income tax is deducted from interest payments at source. Other investment income (or interest paid to higher rate taxpayers) must be reported on a tax return under Self-Assessment.

Capturing investment income for LVIT purposes would require the reporting of this income (by tax return or other method) annually by the taxpayers in receipt of it, and is likely to involve prohibitive costs. In practice it would be easier to exclude investment income from the LVIT net. ‘Earned income would be subject to two levels of income tax – national and local.... Investment income would be subject to one (potentially unchanged) level and rate of income tax – the current national system.’ [CIPFA, 2004, p7]

Conclusions

The introduction of LVIT as a Core Tax brings with it many benefits: it allows local authorities to have more choice and control over how they structure local taxes, and how they distribute the local tax burden between different classes of taxpayer. LVIT is also a progressive and buoyant form of taxation, improving the ‘fairness’ of the local taxation system and providing local authorities with a form of taxation which responds automatically to changes in local tax base.

This provides a counterweight to regressive and non-buoyant local property taxation.

It is clear that the design of a workable LVIT system will need careful thought and discussion to resolve some of the technical issues identified. However, these technicalities should not prohibit the introduction of LVIT and the real benefits it could have for local autonomy.

6. Detailed Analysis of Reforms, 4: The Discretionary Local Taxes List

As discussed in Chapter 2, in addition to the three ‘mandatory’ Core Taxes, there will also be available a pre-approved Discretionary Local Taxes List from which local authorities will be able to pick and choose additional local taxes with which to raise extra revenue to finance local services.

The purpose of the Discretionary Local Taxes List

The purpose of the Discretionary Local Taxes List is to provide local authorities with increased flexibility and additional power over their finances. The taxes on the list are entirely optional; local authorities can implement all, none, or some of the taxes as they see fit. Subject to the conditions set out below, they can be introduced on a temporary or permanent basis, and the income streams they generate can be used to supplement the general revenue raised from

the three Core Taxes, or it may be hypothecated to a particular service area.

Local authorities may also choose to introduce additional taxes so as to reduce the proportion of income they raise from the three Core Taxes.

The list, although pre-approved and published annually in advance, is not fixed. Local authorities will be able to petition central government to approve additional taxes, and add to them to the list, and indeed, central government itself will have the power to add taxes to the list.

Features of the Discretionary Local Taxes List system

(i) The use of the discretionary list will be entirely flexible. Whether or not the taxes on the list are implemented is entirely at the discretion of each local authority; they may choose to implement all, none, or a selection of the discretionary taxes available. These taxes may become a permanent feature of individual local finance systems, or may be temporary, funding specific projects or boosting local revenue over a discrete period. Local Councils may also choose to implement one or more discretionary taxes to ease the pressure on, or vary the weighting between, the three Core Taxes.

As with the Core Taxes, there will be no imposed conditions on how the revenue raised for local taxes is spent. However, authorities are free to hypothecate the income raised from the discretionary taxes to specific spending areas if they so wish, particularly if they think this would make the introduction of the additional taxes more palatable to their local electorate. The onus is on local authorities to examine how the additional taxes will fit into their local system.

(ii) All discretionary taxes on the list will be pre-approved centrally and pre-published

The list will be comprised of a set of potential local taxes that have been pre-approved by central government, and will be published annually in advance, allowing local authorities to consider available options when setting their budgets.

In choosing any of the discretionary taxes, local government will have to conform to any guidelines that central government has set regarding those taxes.

(iii) A local referendum, or other democratic process, will be necessary to introduce any of the additional discretionary taxes into the local revenue raising system

As part of our ‘Ten principles of a good local finance system’ (see Appendix 1) we put forward that ‘The local government finance system should strive for maximum transparency in regular budgeting and involve local people in major financial decisions as much as possible.’ We therefore propose that local authorities be required to put the implementation of any new discretionary taxes to a local referendum.

By directly involving the local electorate in the decision to add new taxes to the local basket, the transparency of the local finance system and the accountability of local councillors would greatly improve. Local councillors would have to ‘sell’ the additional taxes to local taxpayers, who would then be free to accept or reject them.

(iv) Local government may petition central government to approve additional discretionary taxes

The discretionary list, although pre-approved, will not be finite or

fixed. Local authorities that wish to introduce an additional local tax not on the list will be able to put their case forward to central government for approval.

In applying for approval, local authorities will have to demonstrate that the tax desired is relevant to their local tax base, and central government would review the proposed tax for legality and any clashes with national taxation. If approved, the new tax will be added to the Discretionary Local Taxes List and will be available for use by all local authorities.

(v) The discretionary taxes used by individual authorities will not be taken into account when calculating equalisation grants. Discretionary taxes implemented will not be taken into account when calculating central equalisation grants to local authorities. There is further discussion of equalisation in Chapter 9, but it is important to note that non-equalisation of some local taxes is not a new feature of the English local finance system. There already exist local taxes, eg congestion charges and parking charges which take advantage of local resource bases and are not equalised for when calculating the Revenue Support Grant.

It is envisaged that the discretionary taxes on the pre-approved list will only be capable of raising fairly minor levels of local income relative to the three Core Taxes. Excluding these taxes from equalisation calculations recognises their minor role; if these revenues were equalised nationally the benefit of the discretionary list would be lost and it is likely that local authorities would not introduce any of the discretionary taxes available to them for fear of the negative impact this would have on their equalisation grants. This conforms to current policy with respect to unique

local taxes which are not included in the calculation of the Revenue Support Grant (RSG). For example, the congestion charge scheme which operates in London is a local tax unique to London. The monies it is capable of raising are potentially significant but there is no attempt to equalise for these revenues when calculating RSG, and no one would suggest that there should be. The operation of the taxes on the Discretionary Local Taxes List will be no different to this.

A sample Discretionary Local Taxes List

Box 1 shows a potential pre-approved discretionary list that could be published by central government. Though neither exhaustive nor final it provides a good example of the kinds of taxes which we envisage forming the discretionary element of local taxation.

Box 1 – Sample Discretionary Local Taxes List

- Tourist bed taxes
- Green taxes – eg the plastic bag tax
- Pet licensing
- Local congestion charging
- Off-street parking charges

Conclusions

The Discretionary Local Taxes List aims to re-empower local authorities, giving them back control over local tax bases and revenue generating ability. It will sit alongside the three Core Taxes, allowing

local authorities to supplement their income and increase the number local taxes at their disposal.

Local government will also be able (as long as approval is achieved) to introduce additional locally relevant taxes in response to their local tax bases/local conditions. The direct involvement of the local electorate in the addition of discretionary taxes will increase transparency, and improve local accountability both in the setting of taxes and spending of local revenues.

7. Detailed Analysis of Reforms, 5: Charges for Services

The importance of charges and fees

The importance of revenue generated by charges and fees in local authority income is often overlooked. In 2001/02, income from charges and fees (including rents) amounted to 12% of local authority gross income, being only 4% less than council tax income in the same year. [ODPM, 2004, Local Government Financial Statistics, England, No14, Chart 2.1b]. Under the current system, local authorities are able to set fees and charges for the local services they provide, except those mandatory services for which provision must remain free (eg, education, police and fire services and library borrowing for books).

The present system: The Local Government Act, 2003

The Local Government Act, 2003, has given local authorities new powers to charge for locally provided services.

Under the new provisions, Best Value authorities are able to charge a fee for any of the discretionary services they have the power to provide. 'Discretionary services are those services that an authority has an express power to provide but does not have any statutory duty to do so.' [ODPM, 2004a, p50, footnote 2]. Fees and charges may be structured in any way the authority wishes but the amounts charged for the services may not exceed the cost of their provision (ie, local authorities may not make a profit on the provision of these services). The Secretary of State retains the discretion to rescind the charging powers at any time.

These new powers do not override existing legislative powers to charge for either statutory or discretionary services (nor do they undo any previous statutory bans on charging); they are a simple extension of the existing charging rules.

[The Local Government Act 2003, does provide new powers for local authorities to partake in profit generating trading activities with respect to service provision. However the conditions relating to the operation of trading activities are fairly restrictive; they can only be conferred by the Secretary of State, and only to high performing local authorities (or authorities which have achieved strong performance in the delivery of certain services). The extended powers to trade can only to be used to aid the achievement of Best Value in the delivery of services, and the trading itself may only be carried out via companies.]

Our recommendations: Extending the charging powers even further

We welcome the new provisions under the Local Government Act, 2003, for charging in relation to the provision of discretionary

services. We propose that the powers be extended even further, allowing local authorities to view charges as an important tool for raising local revenue.

(i) The proposed powers for local authorities to charge for discretionary services

Under our proposed system of local finance local authorities will have the power to:

- i. Charge for the provision of any discretionary service they have the power to provide.
- ii. All mandatory services for which there is a statutory duty of provision (eg police and fire services) and which are exempt from charging by current statute, should remain so.
- iii. The structure of the charges should be entirely at the discretion of the local authority – this could include differentiation in charges to various user groups, the linking of charging to means-testing of income, the introduction of exemptions and discounts, and, if desired, the provision of the service entirely free of charge.
- iv. Local authorities should be allowed to compete more directly with the commercial sector in providing the kinds of discretionary services which could also be supplied on a commercial basis (eg pest control, CCTV provision), and as such should be enabled to charge a commercial rate for the services and make a profit on their provision if they so wish.
- v. Those services which could not be operated on a commercial basis (ie for which there is no local commercial market) should have any charging structure restricted to the recovery of cost

(eg, pre-application planning advice, discretionary registration services)

- vi. The discretionary power of the Secretary of State to rescind charges should be abolished.

Increasing the scope of charging powers enables local authorities to provide, or not to provide, as wide a range of services as they see fit. Currently local authorities have the power to provide many services, some which could not be operated on a commercial basis (eg, planning application advice) and some which feasibly could (eg, pest control).

(ii) Charging for non-commercial services

Allowing local authorities to charge for non-commercial services should help broaden the range of services that local authorities provide. If local authorities cannot charge local residents for a discretionary service, the service may not be provided at all, as to do so would mean transferring scarce resources from the provision of other (possibly mandatory) services.

Allowing a matching charge to cover the cost of provision would encourage local authorities to provide a wider range of services, and to use the service revenues to reinvest in their future provision. For non-commercial services that would not/could not be provided by the public sector, keeping charges restricted to cost is necessary to prevent unfair charging of local citizens.

(iii) Charging for commercial services

For those services for which a local market exists, we would argue that local authorities should be able to compete on a level basis with the private sector and should therefore be able to make a surplus on

their provision of the service – this would be similar to the ‘Public Prices’ system of charges in Spain which applies to those services for which Spanish citizens can choose between local government provision or private sector provision. For these services in Spain, fees and charges must be set at a level at least equal to cost, such that local government is not subsidising the provision of the service, but Spanish municipalities may set public prices above cost levels if they believe they can generate a profit from the provision of the service.

In providing commercial services, local authorities will have to adhere to competition policy and any guidelines issued by central government to prevent unfair competition.

The revenue raised from charging for discretionary services should not be ringfenced in any way.

Conclusions

Charges for local services make up a relatively large part of local authority income in England. Our proposals build on the extended powers for charging enshrined in the Local Government Act 2003, allowing local authorities to structure the charges for service provision as they see fit, and allowing them to make a profit on those local services which have a commercial alternative. This will enable local authorities to take complete control over discretionary services, and will help broaden the range of services they provide. More importantly, it increases the autonomy of local authorities to raise revenue from local sources, which can then be used on any aspect of local spending.

8. Detailed Analysis of Reforms, 6: Specific Grant Finance

Before going on to analyse the role of general grant finance and the system of equalisation with respect to our proposed reforms, it is important to review the role of specific grants.

The role of specific grants in the current system

Specific grants are a form of ringfenced financing provided to local government by central government. These grants are effectively direct payments by Whitehall to fund those services it deems necessary for local authorities to provide. The funds provided are tied to those service areas and cannot be spent elsewhere.

The role of specific grants in local government income has risen dramatically in the last decade. 'Within AEF (Aggregate External Finance), 17.3% of grants are specific and special grants in 2003-04, up significantly from 5.0% in 1995-96... Specific grants inside AEF

went up from £1.8 billion in 1997-98 to £9.2 billion in 2003-04, an increase of over 400%. [ODPM, 2004, Local Government Financial Statistics, England, No14].

Specific grants are allocated by category of spending, and some of the grants allocated within the overall service functions are for very narrow spending definitions, eg, in 2001/02, £158m was allocated to 'Education Provision for 3 year olds' via specific grant finance. [ODPM, 2004, Local Government Financial Statistics, England, No14, Table C2b].

From 2006, changes have been announced to finance all schools funding via specific grants, 'This has been made possible by the introduction of a new dedicated Schools Budget: a grant from the DfES to each local authority, to cover the full cost of delegated budgets for individual schools, and other services for pupils provided by LEAs...Funding will continue to be channelled through local authorities, but cannot be diverted to other purposes.' [DfES, School Funding from 2006-07 - summary of proposals, p1. <http://www.teachernet.gov.uk/docbank>]

The benefits of reducing local reliance on specific grants

Ringfenced finance in the form of specific grants effectively imposes central government decisions over local government spending. The clear effect of this is to constrain local spending patterns in an attempt to meet central policy initiatives. The use of specific grants reduces the autonomy and the adaptability of local government - instead of reacting to local needs and service requirements, local authorities find themselves acting as the agent of central government.

The rise of specific grant levels relative to those of general grants (to a position where they almost match the levels of general grant financing) has caused a steady erosion of local autonomy over the last decade. This has been further exacerbated by the requirement for local authorities to ‘passport’ portions of the main general grant into specific service areas, as well as the introduction of targeted grants.

Reducing the levels of specific grants within overall local government finance will increase local authority freedoms and prevent central government from steering local spending decisions by attaching conditions to finance. More importantly, local authorities will be free to use the financial resources at their disposal to properly react to changing local needs.

A reformed system of specific grant finance

(i) Overall aim of the reformed system

Under our proposed reforms the majority of centrally distributed finance will consist of non-ringfenced general grant financing. The role of grants should be to equalise differences between local authority spending needs and resource bases, rather than being a tool for imposing central spending decisions on local authority budgets. As such ringfenced financing and specific grants should be the exception rather than the norm.

The overall aim is not to reduce or remove the services currently financed by specific funding, but simply to finance them through the general grant or locally generated income. Local authorities will still provide the range of services provided currently, but will be free to allocate the funding themselves. These proposals do, therefore,

represent a radical departure from the current policy to fund schools via specific grant funding from 2006.

(ii) The role of specific grants within the reformed system

Specific grants do have a role to play in local government finance but the emphasis of this role should be changed from one of a principal/agent relationship between central and local government, to one where specific financing is used as a temporary reactive measure in exceptional circumstances.

In other words the role of specific grants would be limited to supporting individual local authorities through (temporary) periods of hardship caused by unforeseen circumstances eg a localised natural disaster which is affecting local revenue collection in the short term (in a similar way to the current Bellwin Formula which uses specific grants to help local authorities who have suffered due to severe weather conditions). Allocations of funding on these terms will be carried out on a case-by-case basis, with local authorities needing to prove that their local income streams have been detrimentally affected.

Additionally, specific grants could be used to provide transitional funding support for new service initiatives that central government may want to encourage local authorities to take up. The onus would be on local authorities to decide if their localities would benefit from the provision of the suggested service (and therefore the additional ringfenced funding) rather than central government simply allocating additional funds and 'forcing' the service to be provided.

Targeted grants, and any form of passporting of general grants, should be abolished.

(iii) Specific grants will be limited in their size and duration

The exceptional nature of specific financing within the reformed finance system will be underlined by specific grants being limited in both their financial magnitude, and the time period over which they are allocated.

Specific grants will be limited to a overall percentage of total grant for each local authority in question; we would suggest a maximum level of ringfenced financing in the region of 3-5% of all central grants to any one authority in any one year. There will also be a maximum time period of three years attached to the grant of any class of ringfenced finance.

Local authorities given specific grants will be aware of the maximum time limits attaching to them and should therefore plan their budgets (and alternative revenue raising measures via the use of the core and discretionary local taxes) to enable them to cope when the grants are eventually withdrawn.

Where the level of specific grant support is relatively high in a local authority's overall finances (particularly in the first year of allocation) central government may chose to phase the grants out at a reducing rate so as to aid local government plan around their withdrawal.

Conclusions

Current high levels of specific grant are a direct constraint on local authority freedoms. By making all types of ringfenced financing the exception rather than the rule, local authorities will be free to use central financing to meet the costs of providing services that their localities want and need, rather than simply being dictated to by Whitehall.

9. Detailed Analysis of Reforms, 7: Equalisation and General Grant Finance

What is equalisation and why is it necessary?

Equalisation is essentially a method of recognising that not all local authorities are in a broadly equal position to provide public services, given different levels of local taxable resources and expenditure needs. Equalisation therefore aims to smooth out the variations in local tax base (s) providing a more level, or equal, base for finance.

(i) Needs equalisation vs Resource equalisation

As noted, there are essentially two differentials which are deemed to require equalisation: local resource base variation, and local needs variation.

Equalising for differences in resource bases is necessary in the interests of fairness; some local authorities will simply not be able to raise as much resources as others (and therefore potentially not

be able to meet their spending requirements) because they have fewer chargeable properties and/or relatively low-value properties for Council Tax. Resource equalisation can be carried out on fairly objective terms as local tax bases are easily measured and compared.

Equalising for differences in spending need, ie recognising that some local authorities will have a higher spending need than others because of demographic or social factors, is often a value judgement. Some factors are clearly indicative of the costs of spending, eg, an authority with high numbers of school age children will necessarily need to spend more on education services than an authority with fewer school age children. But although demographic indicators can be measured, their relationship to 'need' is not always clear cut, and often involves subjective judgement as to the relationship between a need indicator and the cost of providing a service.

Most countries' systems of local finance try to account for both needs and resource equalisation to varying degrees. The English system attempts significant levels of precision and complexity.

(ii) Horizontal equalisation vs Vertical equalisation

Equalisation can occur using either of two methods. There can be a 'vertical' transfer: a distribution of funds from one tier of government to a lower tier of government (as with the general grant system in England). Or there can be a 'horizontal' transfer between government bodies at the same level, ie transfers from richer authorities to poorer authorities.

Some equalisation systems employ just one method; England only uses vertical transfers to equalise needs and resources. Other systems use both methods; Sweden uses a system of horizontal intra-

municipal transfers, but also has minimal vertical grant transfers from central government to local government.

Equalisation and the current system of general grant finance

The following section examines the workings of equalisation within England's system of local government finance.

(i) How does equalisation work in the present system of local government finance?

England has a 'vertical' system of equalisation which attempts fully to equalise for differences in needs and resources for each local authority up to a centrally pre-determined spending figure, known as the Formula Spending Share (FSS).

Central government makes an annual assumption as to how much local government (in total) will need to spend, and this total (known as Total Assumed Spending) is then split between individual authorities on the basis of their calculated FSS.

FSS tries to account for all the expenditure needs faced by a local council in a particular year. FSS for each authority is divided up into up into a number of service blocks, most of which have their own more detailed sub blocks (eg education is one of the main service areas, and has sub blocks for primary and secondary education). Each service area FSS is calculated using predetermined complex formulae which attempt to take account of the different social, demographic and other factors which affect the cost of providing the services in those areas. Once each individual service FSS has been calculated for a local authority, these are added together to give the

overall FSS figure for that authority. Within their total FSS figure, each local council therefore ends up with individual service-based needs assessments for each of the main services, and in total.

A local council's total FSS therefore attempts to provide a measure of its spending need relative to all other local authorities in England.

Once this needs assessment has been carried out and FSS is known, central government takes account of resource differences between authorities. From each authority's FSS calculation (ie what central government has assumed it will need to spend in the year) is deducted that authority's share of the NNDR pool (allocated on a per capita basis) and that authority's Share of Assumed National Council Tax (SANCT). The remaining balancing figure is the Revenue Support Grant (RSG) that central government will distribute to the authority. '...the broad effect is that if every authority set its budget at the level of its FSS...the Council Tax would be the same for all properties in the same valuation band throughout England - the assumed national council tax level.' [ODPM, 2003b, p 8]

England operates a system of 'vertical' 'point' equalisation; needs and resources are equalised for all authorities for spending levels at FSS. Councils which spend above FSS will not receive additional grant, but will have to raise Council Tax levels to make up the deficit. Councils which spend below FSS, however, will not lose grant.

(ii) What are the problems with the current system of equalisation/central grants?

The problems with the current system of equalisation (and central grant allocation) divide into two themes: issues with grant calculation itself, and issues created by the reliance of local government on central funding.

- *Issues with grant calculation*

The current system tries to equalise for all aspects of council expenditure. 'It is probably fair to say that no other country in the world goes to such lengths as the UK to fully equalise needs and resources.' [ODPM, 2003a, p7]. There is an overarching desire for equal outcomes and uniform service provision which is partly driven by public expectation, but also reinforced by a local finance system which involves Whitehall trying to second-guess every possible spending requirement a local authority may have.

In trying to account for all spending needs, and variations in Council Tax base, the system of grant allocation in England has become complicated and opaque. It is not well understood even among local finance directors: of the 1,850 local officers questioned in a recent survey, 40% (including 26% of finance directors) felt the need for a better understanding of the Revenue Grant Distribution system [Davis, 2000, Table 4.1].

The formulae which are used to calculate FSS are subjective and controlled by central government ministers. They are a central assessment of needs, which despite being a method by which to provide equalisation, may not even reflect local circumstances. Local authorities have little, or no, say as to how much grant they receive. Central government can vary the grant at whim, and more worryingly has started to impose conditions on how the 'general' RSG grant is spent with measures such as 'passporting' for schools.

- *Issues with reliance on central funding*

Heavy reliance on central funding also contributes to the gearing effect described in Chapter 3.

Perhaps more importantly from the viewpoint of local democracy, heavy reliance on central funding also creates behav-

itorial distortions at a local level by promoting an upward looking local government sector. Despite a desire for more autonomy, local authorities are locked into a system which constrains them into arguing for increased grant levels and ever-more complex changes to grant distribution systems.

Equalisation under our proposed reforms

Equalisation is an important part of any local finance system and we propose to maintain a level of equalisation (and equalisation grants) that conforms to English voter expectations, whilst resolving some of the problems of the current system. No single authority will be significantly better or worse off under the proposed system of equalisation than they are currently.

(i) Main focus of the new system of equalisation

Under our proposals the calculation of equalisation grants will still equalise for differences in local resource base for the three Core Taxes. However, we propose greatly to simplify the process of needs equalisation, both by changing the method of calculating needs assessments, and by handing the process of spending assessment to an independent body. A system of vertical transfers, ie central grants, will be retained in order to make the reforms more palatable and politically feasible.

All equalisation grants calculated and allocated under the new system will be general financing in its purest form. There will be no constraints on how the grants are spent, and all passporting, and other conditions attaching to central financing, will be abolished.

(ii) How resource equalisation will operate

- *The three Core Taxes*

Resource equalisation under the proposed reforms will work on a similar basis to the current system. There will be point equalisation up to the level of the Local Spending Assessment, LSA, (see below) for each of the Core Taxes.

Once the LSA for each authority has been calculated, central government will deduct each authority's SANCT (based on the median band), an assumed level of local Business Rates, and an assumed level of LVIT (see below) As such, the level of general equalisation grant paid to each authority will be calculated as:

$$\text{General equalisation grant} = \text{LSA} - [\text{SANCT} + \text{AvLBR} + \text{AvLVIT}]$$

Where:

LSA = Local Spending Assessment

SANCT = Share of Assumed National Council Tax

AvLBR = an average Business Rate multiplier applied to the local Business Rate base

AvLVIT = the rate by which the base rate of National Income Tax has been cut in introducing the LVIT applied to the local income tax base.

As discussed in Chapter 4, additional levels of equalisation may be necessary to smooth the relative differences in local Business Rate base for authorities with very high Business Rate tax bases. This could take the form of a regional self-financing Business Rate pool, initially for the London authorities, with the possibility of extension to other regional areas if successful.

- *The Discretionary Local Taxes List*

As discussed in Chapter 6, the taxes on the Discretionary Local Taxes List will not be equalised for when calculating general grants.

(iii) A simplified system of needs equalisation: Calculating LSA

As we have already seen, the current system of needs assessment and the calculation of FSS is based on a complex system of formulae relating to service blocks and sub blocks for each local authority. A system whereby central government tries to anticipate every possible variation of local spending need simply strangles local democracy, and creates an opaque system understood by very few.

The current system of calculating an FSS for each service area for each authority will be abolished and replaced with a much simplified system of needs assessment based on broader indicators, eg deprivation indices, population measures and geographical area assessments. In this way, the calculation of LSA will arrive at a one-figure assessment of local spending need, rather than several service-based FSS assessments which need to be added together to calculate each authority's overall FSS.

A good example of a more simple system of calculating local spending needs is already in operation in Wales. The Welsh system uses a system of approximately 60 needs-based indicators to arrive at a single needs assessment for each Welsh authority (known as the Standard Spending Assessment, or SSA). Although the weights of these indicators are set by a combination of statistical techniques and judgement, there are no individual service-based needs assessments as in the English system. The indicators used to assess need in the Welsh system are published annually in the Local Government

Finance Report, and the 2004-05 report shows that there were 61 indicators used in that year. [National Assembly for Wales, 2004, Annex 2].

The Welsh system publishes an SSA unit measurement for each needs indicator which is then applied to the value of that indicator to arrive at the assessment. For example, one of the needs indicators in 2004-05 was 'Secondary school pupils'; the SSA unit for this indicator was £2425.88 [National Assembly for Wales, 2004, Annex 2]. The number of secondary school age children in each Welsh authority is multiplied by £2425.88 to arrive at the spending needs assessment for that indicator in 2004-2005.

There is no reason why a simplified system cannot operate in England. This would remove the need for formulae-based individual service assessments and, in the hands of an independent Grants Commission (see below), would provide an unbiased and clear system of needs assessment.

A simplified needs assessment system will provide a more transparent, readily understandable system, which gives a broad estimate of spending need. LSAs will comprise an overall awareness of differing needs from authority to authority, but will not delve into the minutiae of every single possible spending decision that each local authority might need to make.

(iv) Introducing an independent body for grant distribution

In order to make equalisation a more transparent process, we would recommend that the calculation of equalisation grants be passed to an independent body; a Grants Commission. The Commission will have the job of assessing the resource equalisation, ie the calculation of SANCT, AvLBR and AvLVIT, as well as calcu-

lating LSA for each authority. A similar system operates very successfully in Australia.

Box 2 – Australian Grants Commissions.

Australia has a Local Government Grants Commission in each of its States. These independent bodies calculate the distribution of general purpose grants to the local authorities in their jurisdiction within the level of overall funding made available by central government. Within very clear national principles and guidelines (the need to take into account horizontal equalisation between authorities, and the need to provide each authority with at least the minimum specified grant) each Commission can decide how it assesses needs and distributes general grant to the local governing bodies in its State.

Choice and application of needs-based indicators will be in the hands of the Commission. The indicators used will be published in advance to aid the transparency of the local spending assessment process. Any changes to the indicators used to calculate LSA must be with the agreement of all Commission members, and pre-announced to local government to increase predictability.

The Commission will assess each authority's needs using the indicators chosen and calculate individual LSAs. It will then take into account the assumed levels of the Core Taxes in order to calculate the level of general grant due. Grants will be allocated on the basis of a fixed settlement period, and could be announced to local authorities 1-2 years in advance of each financial year to aid planning and stability.

Using an independent body removes some of the political/centralised aspects of grant allocation being controlled by

Whitehall, and allows an impartial assessment of the amount of equalisation grants necessary to provide a fair distribution of central funds. The Commission will have clear guidelines to follow which will be published and available for local government consultation.

Equalisation: the bigger picture and some larger ideas

Having put forward our proposed reforms to the equalisation system, and the calculation of general grants under our new system of local finance, we believe it is important to look outside of the specific detail of how the system will run, and consider the bigger picture surrounding equity and resource allocation in England. Why has the system of equalisation developed into the complicated process used currently? What are the bigger questions and issues prompted by this analysis?

England's current system of equalisation was born of the increasing desire of central government to pursue equal outcomes and uniformity of services throughout the country. In our previous publication 'The rise and fall of local democracy: A history of local government finance' [Travers and Esposito, 2003], we reviewed changes to the local finance system over the last 200 years and witnessed the constant struggle between the desire for local accountability and the imposition of equity from the centre. 'Territorial inequalities, both in terms of social characteristics and local tax bases, have shaped central government's views regarding the provision and financing of public services...The role of local government has shifted from an adaptive provider of local public

goods, to that of ‘plugging’ the holes left by inadequate national income redistribution policies.’ [Ibid, p13-14]

The desire for uniformity springs from the wide income and social inequalities across England. The resolution of these inequalities is not met by the national and benefits system and therefore local government (under detailed central oversight and through the local finance system) has found itself filling this gap, and effectively acting as the agent of central redistribution policies.

It is also important to note that years of central intervention have helped shape the strong desire of the English voting public for continued territorial equity in public service provision. The push-pull nature of English public opinion (the desire for consistent and uniform provision of key public services alongside the conflicting demand for increased local accountability) has made ‘...any decision to reform local finance and services politically very difficult.’ [Travers and Esposito, 2003, p14]

(i) The problems of a redistributive system of local government
The main problem with central government’s continued use of local authorities as agents of national income redistribution policy is that it has broken the link between local government and local people. Service provision is driven from the centre rather than being a response to local needs and desires.

This problem is further exacerbated by the local finance system and the high levels of central funding to local authorities (including the ever-increasing levels of specific grants) which is necessary to attempt to guarantee reasonable uniformity of standards and provision as well as reasonably even local taxes. More wealthy and/or low spend areas are funding service provision in poorer, or high spend areas. This

means that efficient authorities cannot pass on their savings/cost management efficiencies to local residents in the form of lower taxes, and that inefficient authorities have less incentive to seek out more cost effective means of service provision. Overall the local taxpayer loses out; not only is there no direct link between the tax paid locally and the services received, but there is no means to influence local service levels or hold local officials directly to account.

The crux of the issue is that local government can never be an effective method of income redistribution. Income and wealth are still unequal in the UK, and more to the point, local service provision is not uniform nationally. ‘The irony is, that after years of central government intervention, there is still a great variation in the availability and quality of basic services across the country.’ [Travers and Esposito, 2003, p14]

(ii) What can be done: is there a more radical solution?

The preferable solution would be to try and resolve the income inequalities more directly (possibly using the tax and benefits system) so that local government becomes free to provide a variation of services in direct response to local desires, rather than in accordance with central efforts to achieve uniformity. A system of local service provision based on these principles would allow local residents actually to become involved in shaping local spending/services, as well as strengthening accountability.

A detailed discussion of how to structure a more radical solution to income equalities, thus freeing up local government and effectively removing the requirement for needs equalisation, is outside the scope of our current report. However, one possible way to resolve the equity/accountability conflict might be to introduce a system

such as the ‘Citizen’s Income Scheme.’ Citizen’s Income aims to make a cash payment to every citizen funded by a reduction in tax allowances and means-tested benefits. This would provide everyone nationally with a minimum income level thus reducing income inequalities up to the level of the payment given. Individuals would then be free to use this income to buy local services, or indeed to spend the money elsewhere, and local government could be free to provide the services requested without central government needing to intervene to resolve basic inequalities. In the longer term, using the tax and benefit system to redistribute and equalise resources/needs would be more effective than trying to use local government equalisation for such a purpose.

Conclusion – Our system of equalisation: a compromise

Local government can never really be free to function as a largely autonomous area of government in England (ie, adapting to and providing services directly to meet the requirements of local people) whilst it is the tool of central income redistribution policies. However, making local authorities ‘free’ means the English voting public must learn to accept that freedom (both for local government and local citizens) is likely to result in disparities in provision and service allocation. This would entail abandoning years of ingrained expectation regarding uniformity, which cannot be expected to occur overnight.

The system of equalisation that we recommend is one which reaches a compromise between providing a level of resource equalisation (which will always be necessary) but also recognises that

overarching needs equalisation does not in practice eliminate inequalities nor provide an efficient system of grant allocation. We believe this takes into account the public desire for a level of 'central' guarantee on uniformity, without maintaining the most onerous aspect of the current system of equalisation.

The proposals put forward in this chapter of full point equalisation up to the level of LSA, does not constitute a purist regime of unadulterated local freedom and diversity. We have chosen this route of central grant allocation and distribution over alternatives (eg the system of horizontal transfers operating in Sweden/Germany, which remove central involvement) to reflect the political climate in England and to make the reforms more politically feasible.

10. Conclusion

The system of local government finance in England has been endlessly reformed in recent history. It has been the catalyst for much political debate and has even been the downfall of prominent politicians. It is our view that a radical and wide-reaching reform of the local finance system is long overdue, and ultimately necessary if local democracy is to be revived.

The package reforms we recommend aims to correct the shortcomings of the current system of local finance, whilst taking into account current political realities. We believe the proposed reforms provide a solution that is both radical and politically feasible, returning autonomy to local government whilst retaining a workable balance between concerns about national equity and local control.

Appendix 1:

The Ten Principles of a Good Local Finance System

1. **The local finance system should ensure that local authorities have the power and responsibility to raise locally most of the funding for the services which they provide.**
 - No less than 50% of local revenue should be raised through locally determined taxes and charges in all authorities, and most local authorities should be raising 75% of revenue from locally determined taxes and charges.
2. **Local government should have more than one tax at its disposal: “One club golf does not work.”**
 - Having just one local tax puts undue strain and pressure on that tax and can undermine the stability of local government service provision.
 - It is also highly unusual by international standards.
3. **The basket of taxes available to local government should be no less buoyant than those available to national government.**
 - Buoyant taxes rise automatically with national income and inflation. Council tax does not.
 - Buoyancy is crucial for stability and local finance systems should mirror the stability afforded to national systems which rely on buoyant taxes such as income tax and corporation tax.
4. **Fairness requires that the basket of taxes available to local government should be progressive wherever possible.**
 - Council Tax penalises the asset rich and income poor (eg pensioners) and is therefore regressive.

5. The collection of any new local taxes should ‘piggy back’ as much as possible on existing collection/administration systems.
 - Any new local taxes should avoid the cost of additional bureaucracy.
6. The basket of local taxes should include a form of property tax: “Buildings don’t move.”
 - Property provides a secure asset base.
 - Property taxes are easy to administer and collect.
7. Local government should have greater freedom to introduce and vary charges for local services.
8. Local government should have greater freedom to borrow on capital markets within minimal prudential restrictions that guard against over-indebtedness.
 - Local authorities should have the freedom to use appropriate sources of finance to fund capital investment whether from central government, banks, bonds or leasing.
 - Local authorities should take the necessary measures to minimize their costs of borrowing, eg, through getting credit ratings, or offering security.
9. Methods of equalisation should focus on tackling extreme differences in overall local spending needs, and the capacity to raise taxes locally, BUT should not seek a level of precision which implies Whitehall second guessing each authority’s response to local spending requirements.
10. The local government finance system should strive for maximum transparency in regular budgeting and involve local people in major financial decisions as much as possible.

Appendix 2

Examples of Possible Outcomes Under the Proposed System

As these scenarios show, it is entirely possible, within the framework of the proposed system, for a local council to maintain the status quo when choosing how to structure its local finances. Alternatively, the system also allows local authorities to radically change the taxes with which they raise their local revenues. The flexibility and adaptability of our new system is its most notable strength.

These scenarios are purely examples and only represent three of the many possible combinations of local taxes which could be chosen. They are not by any means an exhaustive list.

Scenario A

Local authority 1: Maintaining the Status Quo

Core Taxes

- Retains Council Tax at current rates
- Sets the localised Business Rate at current rate and links future increases to retail prices (ie inflation)
- Sets LVIT at the tax neutral rate (4%)

Discretionary Taxes

- None introduced

General grant financing

- Central funding to fully equalise for spending needs and resources up to the level of the local spending assessment distributed by the Grants Commission

Scenario B

Local authority 2: Introducing LVIT to reduce Council Tax*Core Taxes*

- Sets a minimum level of Council Tax
- Sets a local Business Rate multiplier which is then linked to Council Tax rises
- Sets LVIT at the maximum possible rate (6%) and raises most of its local income from LVIT

Discretionary Taxes

- None introduced

General grant financing

- Central funding to fully equalise for spending needs and resources up to the level of the local spending assessment distributed by the Grants Commission

Scenario C

Local authority 3: A low Business Rate with a thriving tourist industry*Core Taxes*

- Sets Council Tax at a higher rate
- Lowers the Business Rate multiplier and limits rises in the multiplier to inflation
- Sets LVIT at the neutral rate (4%)

Discretionary Taxes

- Local Tourist Tax introduced (via referendum) to tax tourist beds

General grant financing

- Central funding to fully equalise for spending needs and resources up to the level of the local spending assessment distributed by the Grants Commission. The Tourist Tax is not accounted for in calculating the equalisation grant

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