GREY HAIRS

THE EXPERIENCED CONSULTANTS

Local Authority Funding

Appendix I

Reforming Tax, Benefits and Local Government

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Isitfair is an organisation campaigning for the reform of the Council Tax. This paper considers replacing the present funding of Council Tax with increases to national income tax and VAT. However, Isitfair recognises that this is just one of the possible alternative approaches to relieving the hardship being caused by the Council Tax in its current form.

1. Introduction

As we noted in section 3 of the main body of this document, any discussions on tax which fail to take into account the possible countervailing benefits are probably futile. What really matters is the **overall** effect of **all** taxes and benefits when **taken together** on particular types of individual or groups of citizens.

In a similar way, any discussion of taxation which does not also address the issue of **representation** is also likely to be futile. It is worth remembering that the American Declaration of Independence was precipitated by just this issue. This becomes particularly important when considering the proper balance of funding and the proper balance of power between local and central government.

Most of the pressure from the electorate seems to be in favour of reducing the share of local revenues collected locally and increasing the share contributed by central government. Paradoxically however, most people also seem to want more local autonomy or democracy! These apparently contradictory views probably represent an inchoate feeling that the state is too big and that council tax is unfair and / or too high. These views are most definitely **not** contradictory, (although they may not necessarily be right!).

2. Reforming Taxation

2.1 Criteria for reform - Good and bad taxes

The essential criteria for a "good" tax are:

- The impact of the tax must be **predictable**. Those who impose the tax must know how much it is going to yield and those who pay it must know how much they should budget for **in advance** - or at least what their disposable income after the tax will be.

- The tax must not cause undue hardship for any of those who have to pay it - taxes have to be **affordable**

    — Taxes which are automatically affordable are those which are based on one or more of net income, net wealth, spending or windfalls, (such as inheritance). People or residency based taxes, such as the poll tax, (and to a slightly lesser extent, the Council Tax), are not **automatical**y affordable.

    High taxes, as well as damaging the economy, tend to become more "unaffordable" than low taxes - whatever the basis on which they are actually collected.

- Its imposition will do minimum damage to the economy.

  — No transaction based tax really meets this criterion. Sales taxes, customs and excise taxes and taxes on earned income are all transaction based taxes. The whole economy is based upon transactions. Indeed, this is the basis of measuring GDP. Without transactions no economy would exist. The transactions that take place in a free market economy are those where each side values what it receives more highly than what it gives up. Any taxation levied on such a transaction tends to eat into this surplus of value created for one or both parties. With high taxation, there are simply bound to be some transactions which become unattractive to at least one of the parties. Such transactions would not then take place and the economy would suffer.

  Most local transaction based taxes are especially damaging to the local economy since they tend to displace economic activities to other localities where transaction based taxes are lower.

  Classical economic theory would suggest that **all** subsidies or taxes designed to encourage or discourage particular forms of economic activity actually harm the economy. This means that taxing "bads" like road fuel, tobacco or alcohol, or subsidising "goods", like railways, ought to cause real damage. Actually however, taxing road fuel, tobacco and alcohol is not nearly so damaging as classical economic theory would indicate, because these goods have a very low price elasticity of demand. This is what makes them a good source of revenue - and taxing them a correspondingly bad way of reducing consumption!

- The tax must be "fair" and **non-discriminatory**

  — Taxes which are widely seen as "unfair" tend to be evaded and / or avoided. In extreme cases they can even lead to civil unrest, (c.f. the poll tax)

  Unfortunately people differ in their concepts of what "fairness" actually means. Many people appear to believe that taxes whereby they end up paying more are less fair than those which end up with their paying less. However they can only all be right if taxes are virtually zero. It would seem that "fairness" in taxation is a nebulous concept lying mainly in the mind of the contemplator.

  To us fairness means treating similar things, or similar people, in similar ways, avoiding any form of discrimination whatever. In practice this probably means that only flat rate taxes are completely fair.

- Its imposition will bear a direct relationship to the expenditure that it is supposed to fund and who benefits from, or votes for, that expenditure.

  — It is obviously sensible that those who use non-essential services, (like television), should pay for them through a licence.

  Giving people the power to vote for taxes which they do not pay is very dangerous. If the taxes can be spent on things that benefit them, (and some of them will be), they have a perverse incentive to vote for high taxation and correspondingly high expenditure even though this might be inefficient or economically damaging.

Unfortunately governments dislike hypothecated taxes whereas the electorate tends to prefer them. People dislike paying taxes for activities of which they disapprove. For example, pacifists dislike paying for armaments whereas pro-life campaigners dislike paying for abortions on the NHS. Hypothecated taxes reduce a government's freedom of manoeuvre and their means of exercising power over us.

- It must be easily, efficiently, and cheaply collected and difficult to avoid

— All real estate based taxes meet this criterion - real estate can not be moved away! Usually other forms of wealth tax do not - other sorts of wealth are too easy to conceal. On the other hand, national income and sales taxes only meet these last two criteria somewhat imperfectly. Local sales and income taxes do not really meet it at all well - incomes and transactions can be made to look as though they were earned, paid for or took place elsewhere. On a **national** basis people or residency based taxes, (such as the poll tax), also meet these criteria, whereas on a local basis people or residency based taxes meet them somewhat less well. Licence based taxes, (such as the TV licence, road fund licence, congestion charging, car parking fees etc.), only meet these criteria to a limited extent

Generally, taxes that are simple, straightforward and easily understood by those paying them as well as by those collecting them are the easiest and cheapest to collect and the hardest to avoid. Tax avoidance is facilitated by complexity, (which is usually introduced for social engineering purposes or to encourage or discourage particular activities of which the government approves or disapproves), since it allows the avoider to make his taxable base appear different from the real underlying situation. The higher the tax is, the greater is the incentive to engage in avoidance schemes or even outright evasion. The well known Laffer curve points out that there is always a tax rate above which rate rises reduce the tax take. Income taxes and VAT are both widely avoided and evaded as are excise duties like tobacco tax.

2.2 Local taxation

There appears to be a widespread demand for **more** local democracy and **less** centralisation. We fear that unless there are **some** taxes which are collected locally and particularly whose **rates are set locally**, then any local autonomy that still remains will rapidly become a sham. Local **collection** is not enough. Only if those who decide how to spend the money are able to decide **how much** to spend and collect by way of tax are they truly accountable. Tax rates for local taxes really do need to be **set** locally.

Any local tax needs to be cheap and easy to collect and difficult to avoid. In practice this means that its imposition will not, of itself, tend to displace the taxable base to other, slightly lower tax, authorities. A truly local income tax does not really meet these criteria. It is too easy to make it appear as though the income was earned or received somewhere else. Besides who should benefit from the tax - the local authority in which the income was earned or the local authority in which the earner resides? We can see arguments for both answers. Local sales taxes, such as local VAT, local excise duties or local customs duties, whose rates are set locally, do not meet these criteria either and so should also be ruled out. They would tend to do too much harm to the local economy through displacement.

Ideally any local tax would be "fair" and non-discriminatory, broadly based and avoid any undue hardship for any of those who have to pay it. Also it should be fairly obviously "local". Ideally too its incidence will bear a direct relationship to the expenditure that it is supposed to fund and who benefits from, or votes for, that expenditure.

Given all of these criteria, it is very difficult to avoid some form of property based taxes, (like the rates or the Council Tax), or a residents tax, (i.e. a poll tax). Nothing else is truly local.

2.2.2 Reforming the Council Tax

The proposed revaluation of properties in 2005 and the possible introduction of more bands to the existing system, to be implemented in 2007, provides an excellent opportunity for reforming the Council Tax. Unfortunately, because of past experience - where politicians from both central and local government have used past revaluations, (of the rates), and changes to the system, (the introduction of the Community Charge), as an opportunity to extract more taxes from the population while blaming the increases on the change - the prospect of revaluation is already causing concern. This **ought** not to be the case. If politicians were honest (?!?!), they would have to admit that revaluation, in itself, does not cause either central government's or local government's costs to increase. This means that revaluation does not provide any excuse whatever for raising more revenue by way of the Council Tax or for cutting back on central government grants.

If properties were to be revalued and rebanded in accordance with a **local** property price index rather than **national** property prices then we could achieve one of two possible desirable outcomes:

- What was originally, (for example), a band D house before revaluation would tend, on average, to remain a band D house afterwards with a similar situation applying to houses in other bands

- Similar properties in different local authority areas would be assigned to similar bands.

The first approach would defuse much of the worries associated with revaluation whereas the second would help to address the perceived unfairness of the South **appearing** to subsidise the North. Unfortunately these two desirable ends are mutually incompatible. The current distribution of houses into different bands differs too much from one local authority to another, (see for example table 6 in section 2.4 of the main document).

The first approach would have very few winners and very few losers. This would be the ideal approach for a quiet life. However there would be very little redistribution and therefore very **little real reform.**

On the other hand, the second approach would lead to many more of both winners and losers. These winners and losers **in real terms**, would be concentrated in those areas where the existing banding distribution is skewed towards either the high bands, (as in London), or the low bands, (as in the North East), when compared with the national average. In **reality**, the redistribution involved would make the Council Tax **less regressive** than it currently is **locally** and fulfil the **national** objectives of its designers which was that those living in bigger or better houses should contribute more than those in less "desirable" properties. In this sense it would be much "fairer" than the current system..

On its own, this reform would only redistribute the burden **within** local authorities. It would do nothing to redistribute the burden **between** local authorities. However this might not be what is **perceived**. The North might well feel that it is losing out with respect to the South, even though this would be untrue.

When the Council Tax in its present form is combined with Resource Equalisation it rewards the wealthy in some areas, (such as the North East), at the expense of the poor in others, (like London), simply because house prices are much higher, (and are already therefore more of a burden on incomes), in the latter than they are in the former. In effect what the Resource Equalisation system does is to tax people on the basis of their **neighbour's** prosperity. Not everybody in the South East is well off! If the Council Tax were to be retained in anything like its present form, then we believe that the key reform that would be absolutely essential is the reform of the Resource Equalisation system.

If we were to revalue houses on a regional basis for banding purposes then houses in some English local government regions would tend to be re-banded **upwards** while in other regions houses would tend to be re-banded **downwards** so that all regions would then have more or less the same percentage of housing in each and every band as the national average. In what were, (in 1991), the cheaper housing areas, (i.e. the North East, the North West, Yorkshire and Humberside, the East Midlands and the West Midlands), the predominant change would be upwards. In the more expensive areas, (i.e. London, the South East and the South West), the predominant change would be downwards. Most of these changes would involve a movement of one band only.

One can well imagine that such wholesale changes might cause consternation. However, other things being equal, the main practical effect of re-banding **upwards** would be that the Council Tax charged for any particular band would go **down**, (since the taxable base has now increased). On its own, such re-banding would only redistribute the costs **within** any local authority - in effect people would no longer be able to rip off their neighbours. Any effect that re-banding might have on the (im)balance of funding from central government **between** regions would only result from further central government action.

In contrast to the situation where a lot of properties move up a band, places in which many properties move **down** a band would, (other things being equal), see an **increase** in the rate of Council Tax on the benchmark band D property, (because the tax base has now shrunk). This would highlight the ludicrous situation that currently applies. It would become obvious that, with no change to central funding, people in any one property band would be paying very different rates of tax which bore no relationship to their own or their area's needs.

If housing were banded with respect to local conditions, then house price variations from one region to another could no longer be used as a basis for redistributing tax receipts between the regions. Most people would feel that owners or residents of broadly similar properties should pay broadly similar amounts of tax. A more **rational** and hence "fairer" system would simply **have** to be devised. This is the real attraction of such a revaluation.

In the technical sense, Council Tax in its present form is a regressive tax. Although the **amount** charged rises as the taxable base, (house price) rises, the **rate** charged *falls* as the value of a house *rises*. There is nothing inherently wrong with this. Much depends upon the overall impact of other taxes and benefits and how progressive or regressive these tend to be, as well as the degree of progressiveness, (or regressiveness), one thinks is appropriate. There will never be complete agreement on this, but most people think that any regressiveness across the whole range of taxes and benefits would be a bad thing.

This regressive effect was deliberately built in when the council tax was devised. The intention was to retain the virtues of both the poll tax and the rates. The virtue of the poll tax was that **everybody** contributed **something**, (however little), to local services and therefore had an interest in voting responsibly on matters related to local government expenditure. The poll tax was of course very regressive. This was one of the reasons why it was so unpopular. Rates were a tax based on an (often notional) assessment of what the property could be let for - a sort of tax on imputed income. They were neither regressive nor progressive. Overall therefore any replacement had to be slightly regressive. Actually, of course, the Council Tax failed to retain the main virtue of the poll tax which was that everybody contributed!

Some proposals for reform involve altering this degree of regressiveness, either by reducing it or even by increasing it. With the present distribution of bands in different areas, the effects would be very disparate.

Many people regard a regressive tax, like Council Tax, as being "unfair" in itself. We make no comment on this point - it is purely a matter of opinion. However it is worth remarking that if this regressiveness were to be removed and Council Tax were to be made proportional to the average valuation of a house within each band, (which is, in effect, what is being proposed as a "reform" in Northern Ireland), then those who are house asset rich but income poor, (like many pensioners), would suffer **even more** than they do under the present system!

The effect of any such change would vary widely from region to region. People in band A properties in the North East would gain the least whereas those in band H properties in the same region would suffer the most. In complete contrast, people living in band A properties in London would gain the most whereas those living in band H properties would suffer the least. In effect those living in high value properties are penalised the most where they are rarest - whereas those living in lower value properties gain the least where they are the most common. This is a result of using **national** value criteria for banding. If we were to band properties relative to other values within the **region**, then the effect of removing the regressiveness of the Council tax would be identical across all regions.

2.2.3 The poll tax

Given all the unrest generated last time around, it might seem somewhat foolish to even contemplate reintroducing the poll tax. However it is worth remembering that when the poll tax was first mooted it received a considerable amount of popular support. The Conservatives included their poll tax proposals in their 1987 manifesto and gained a majority of over 100 seats! It was only when the **size** of the bills emerged that people violently opposed it. A poll tax involving much smaller bills might still be an acceptable possibility. The problems associated with the past implementation of the poll tax were:

- For various reasons, many local politicians took the opportunity to raise the total amount of local taxation while blaming the change in the taxation **system** for the increase. As a result, the total burden of the poll tax was very much higher than that envisaged by the then government's civil service advisors. Also some local politicians used the change in taxation system for flagrantly political purposes. They raised taxes in order to make the tax, and the government that introduced it, unpopular.

- The poll tax proved to be unexpectedly difficult and expensive to collect - partly, one suspects, because there were attempts to mitigate its severity and partly because some local authorities, vehemently opposed to the principle of the tax, made little effort to collect it. There were some advantages in that people who did not want to vote did not have to pay the poll tax whereas those who did want to vote did have to pay it.

- The poll tax was unpopular and seen by many people as "unfair". This was mainly because more people had to pay it than had previously paid the rates which it replaced. Freeloaders, who before contributed nothing, whilst benefiting from local services, were especially outraged. Many of the "can't pay won't pay" brigade were, in truth, simply won't payers.

- The high levels of local tax that coincided with the introduction of the poll tax, (whether due to deliberate politically motivated sabotage, genuinely increased costs of local services or increased obligations imposed on local authorities), meant that there really were some people for whom ability to pay became a real issue.

The real problem with the old poll tax was simply that the bills were too high. The tax was asked to take too large a share of the total burden. (In this context it is interesting to note that when the Council Tax was introduced, the contribution of central government to local government expenditure was increased in order to smooth its passage.) A poll tax can not possibly be the main source of taxation in any modern economy where expensive services, free at the point of delivery, are so numerous.

A poll tax is only sensible if at least one of the following is true:

- The distribution of income and / or wealth is much narrower than it presently is in Britain or, indeed, in most advanced economies.

- The tax is supplemented by other taxes and only covers a small amount of total expenditure. Ideally this should be the expenditure that is more or less discretionary

Since we are not proposing to do anything much about income distribution, it is clear that we could only use the poll tax as a **supplementary** tax. There are a number of "tweaks" that we could consider:

- We could make it a **voluntary** tax. Only those who paid this tax would be entitled to vote at <u>local</u> elections. Anybody who paid the tax would also receive a sort of identity card which would entitle them to use some local authority provided services, such as car parking, sports and leisure centres, theatres, libraries or whatever at preferential rates.

- If the tax were to be made **compulsory**, (as is normal with taxes), we could allow **one** member of any household to offset this tax against their Council Tax, or whatever local tax were to replace it. This offset would replace the current discount for dwellings with single occupants, (one wonders how many of these are really occupied by more than one person), and would ensure that those households with several adults would pay more. The justification for this is that the **total** household income of these households tends to be higher than those households with only two adults and that local services are used by **people**. The more people there are in a household, the greater is the likely usage, (and hence the greater is the likely cost), of those services by people in that household. It seems to be "fair" that those who can afford to make a real contribution to the cost of these services actually do so.

- We could charge a **negative** rate of poll tax for children. It is usually people with the largest families to support who find paying any taxes more of a burden

It is a sad reflection on our society that people don't vote to pay taxes. They vote for other people to pay taxes. As a result, most taxes are seen as iniquitous and unfair by those who actually pay them or on whom the main burden falls. If everybody entitled to vote made some contribution to the services to which they were entitled, then, other things being equal, this would tend to keep taxes low. There would be no "representation without taxation". This is the one great advantage of a **compulsory** poll tax. E**verybody** contributes **something**, (however little), to the local services that they are entitled to use and therefore has an interest in the local authority providing good value for money.

In order to avoid any gerrymandering, or attempts to play one section of the population off against another, it would seem to be a good idea to rigidly index any compulsory poll tax to whatever was the main local tax, (currently the Council Tax). It would probably be sensible to retain this rigid indexing for any voluntary poll tax as well. The problem with a **compulsory** poll tax is that, with some people on very low incomes, anything more than a very low rate for the poll tax becomes, quite literally, unaffordable.

The extra yield **in England** for every £100 of a poll tax charged on all people aged 18 or over would be £3.81Bn. If, (for some reason), those over 65 were exempted, the yield would drop to £3.07Bn.

We note that in their manifesto for the general election of 2005 the Conservatives proposed a rebate of 50% or £500 on Council Tax bills for those over 65. If, purely by way of example, pensioners were to be exempted from paying the poll tax and poll tax accounted for 50% of locally raised finance, most pensioners would find themselves in much the same financial position as under the Conservative proposals. However the actual result would depend upon whether the pensioners were (now) single or a married couple as well as the banding of the house that they live in.

As would be expected with **any** system that involves some funding from a poll tax, the biggest gainers would be those households with small numbers of adults living in expensive housing and the biggest losers would be those households with large numbers of adults living in cheaper housing. Such an arrangement would undoubtedly help those, mainly pensioners, who are housing asset rich but income poor. However it would also give substantial gains to others whose circumstances provide little reason for giving any help. This is almost inevitable with any reformed system of local finance where the total amount that has to be raised is as large as it currently is.

It is interesting to note that if we combine a flat rate Council Tax with a poll tax, the overall impact on the vast majority of households would be much the same as the current Council Tax. This is hardly surprising since it exactly what those who devised the Council Tax intended to achieve!

The discussion in this subsection together with the calculations in Appendix II demonstrate that there is very little to be gained by reforms to any local taxation under the current balance of funding and redistributive arrangements. Local government would have to do less, and be responsible for less, before any really substantial gains from local taxation reform could be realised.

2.3 National taxation

2.3.1 Income tax and corporation tax

According to the Inland Revenue there are expected to be 22.6 million basic rate tax payers in the UK contributing £59.6Bn to the exchequer in 2005/06, while the 3.6 million higher rate taxpayers are expected to provide a further £73.3Bn. Only £20.9Bn of this comes from having a higher rate tax of 40%. The remaining £52.4Bn comes from what is, in effect, basic rate tax on these same higher rate taxpayers. Compared with these figures, the 3.5m who only pay starter rate tax, the 0.9m who only pay savers rate tax and the remaining 6.2 m adults who pay no income tax at all only yield £1.3Bn between them.

When one looks at how little, (relatively) is collected by income tax rates other than the basic rate, it is difficult to avoid posing the question as to why we do not have one single rate of income tax applying across all income ranges. What we are talking about is a flat rate regime for income tax.

Corporation tax is little more than an income tax paid by businesses but subject to different rates and reliefs from those that apply to individuals. We can see little justification for this on any of the grounds of revenue yield, economic performance or "fairness". So far as we can see there is no real fiscal or social justification for the small company allowances. It seems a little odd that one can obtain advantages from a taxation point of view according to whether one is an employee, self employed, a sole trader or a limited company. This is an open invitation to tax avoidance and does not produce the sort of level playing field for competitive markets that most economic theories would prescribe. If corporations and individuals are to be treated in a similar way, then it would seem that only a flat rate income tax would be appropriate.

2.3.1.1 The case for a flat rate income tax regime

There will never be complete agreement on what the appropriate rates of income tax on different slices of income "should" be. Some people, (usually those on lower incomes), would like income tax to be more progressive than it currently is. Other people, (often those on higher incomes), would like it to be less progressive. Leaving such selfish considerations aside, probably the only income tax regime that can be **rationally** defended on the grounds of "fairness" is a flat tax regime in which every single pound of anybody's income from the first pound to how ever many millions they might actually earn, is taxed at exactly the **same** rate. Insofar as incomes from work are concerned, then if (say) the rate were to be set at 20%, this would be equivalent to everybody working one day a week for the common good and four days a week for themselves. Being non discriminatory, (as between one pound and another and between one person's work and another's), this is manifestly "fair".

By using the **work** argument, we inevitably raise the question as to how pensions and investment income should be taxed. To the extent that pensions represent deferred income from work, (as virtually all occupational pensions do), they should be taxed in just the same way as earnings. Equally to the extent that any pensions, (whether occupational or private), are paid for out of schemes which have been more or less tax exempt, they too should be taxed like earnings. Virtually all pensions would be caught by one or both of these two provisions. Investment income, particularly investment income that arises from savings that have already been taxed, should not be taxed in the hands of the **recipient**. Business profits, which represent income from work, should be taxed just like earnings. The taxable profits would be calculated **before** deduction of any **net** rents, interest, (or dividends), paid out. This would have two advantages over the current system for business taxation:

- The current in-built bias in favour of debt finance and against equity finance would be removed. Businesses would then be able to choose the balance that is right purely from a **business** perspective. This would inevitably be good for the economy.

- The economically illiterate bias in favour of retaining profits for reinvestment over distributing them would disappear. Most of the businesses that produce high profits, the so-called "cash cows", (the terminology is taken from the BCG matrix for portfolio management), are to be found in mature or even declining industries. These are the very last places that any investment should take place! On the other hand the so-called "stars" are businesses with strong competitive positions in growing industries. These are the ideal places for investment. What could be more stupid than encouraging investment in the wrong places and discouraging it in the right ones?

Using a scheme such as the one just described, the yield from **existing** income tax payers would be (slightly) **increased** by a flat rate tax of just 20%. The overall yield would of course be higher still. Virtually all those people who currently pay no income tax would be drawn into the income tax net and end up making **some** contribution. Actually of course we would almost certainly choose to impose a higher tax rate than 20% in order to fund the increased benefits, without which the impact on the poorest people in our society would become intolerable.

It is not widely appreciated just how "unfair" our current progressive / redistributive income tax system can actually be in practice. We all know that things like a pint of beer, a haircut or housing are considerably more expensive in some places than they are others. A person in an expensive place living on a given income is considerably worse off in real terms than a similar person on the same nominal income living in a less expensive place. Both however currently pay the same amount in income tax. It is easy to see that people in expensive places can, (and do), easily end up subsidising people elsewhere who in real terms are better off than they are themselves. One doubts whether many of the advocates of income redistribution or progressive taxes would regard this as "fair".

Our current system of income tax is also "unfair" in its taxation of interest received. In an inflationary climate, part of any interest is merely a compensation for the loss of capital value. It seems unfair, as well as economically ridiculous, to tax this portion of interest at all. It only makes sense to tax any remaining portion of interest on a real added value basis.

At one time it was widely recognised that interest was really a transfer payment. It only makes sense to tax **one** side of the transaction - certainly not both. In more sensible times, interest used to be taxed in the hands of the recipient but the payer was given income tax relief. This is the origin of tax relief on mortgages. All such loans used to be treated as tax deductible whether they were for house purchase or any other purpose. Eventually tax relief on mortgages was retained but the relief on loans for other purposes was removed. It was then argued that special treatment for mortgages was "unfair" - which by then it was. However it was the unfair treatment of **other** loans that made it so! Our proposal to tax interest paid rather than received in effect merely removes the economic nonsense of the present system.

A flat rate tax would be much simpler than the current complex system. As a result it would be cheaper to administer, there would be fewer mistakes in its administration, and it would be much harder to avoid.

2.3.2 National Insurance

Originally National Insurance was, (like the Road Fund Licence), one of those hypothecated taxes designed to fund specific items of government expenditure. As its name implies, it was originally an insurance system against the perils of working life and the danger of living too long. It was supposed to fund things like unemployment benefit, industrial injury benefit, sick pay and the state old age pension. This is why people who are not in work do not contribute. Even today, one's entitlement to some of these benefits is dependant upon one's contribution record. In reality of course this is a bit of a sham. There are always other means tested benefits that one can claim instead!

If National Insurance really were a true insurance scheme, then the premiums chargeable would be related to the **risks** of having to make a pay-out and the **size** of any pay-out involved. Since benefits are not earnings related, the case for National Insurance Contributions having an earnings related element is very weak - unless of course one regards National Insurance as a tax just like any other! Given that, in general, it is those towards the bottom end of the income scale who are most likely to have to make a claim against their "insurance", the premiums at this end of the income scale should, from a rational **financial** point of view, be larger than those at the top. The **social** case is, of course, very different!

It is obvious that the yield from National Insurance could be increased by bringing more taxpayers into the net, i.e. those who are not working but are not claiming or entitled to claim any of the contribution related benefits. However, it would seem to be "unfair" to ask people to contribute to benefits which they themselves would never conceivably be entitled to claim! This particular aspect of the system is probably best left more or less as it is now.

There is clearly some scope for raising extra revenue from NICs by increasing the rates or tinkering with the various levels at which these rates become payable, (the government has recently done just this). In this sense NI is like an income tax - but one that is very progressive at the bottom end, very regressive in the upper middle ranges, and almost a flat tax at the top end of the income scale.

National Insurance contributions are paid by both employer and employee - but on somewhat different bases. Self employed people also pay NICs. However the rate at which they do so is less than the sum of employer and employee rates. This can be justified on the grounds that self employed people are not eligible for all of the contribution related benefits. However, it does have the drawback of not producing a level playing field.

Were we starting with a clean sheet of paper and attempting to design a system to fulfil the same objectives as the National Insurance system fulfils today, we would probably have come up with something very different from the complex system that we now have. We would probably have devised some sort of payroll tax payable only by the employer. For these purposes the self employed would be treated in just the same as any other employer. Such a system would allow any sensible subsequent changes to be made with little fuss, (businesses don't have votes). Only the so-called "loony left" would be at all likely to engage in suicidal slaughter of geese laying golden eggs.

The employers' contributions to National Insurance has often been described as a "tax on jobs". This is precisely what it is - which means that one potential advantage of a payroll tax is that discounts could be used as a way of evening out unemployment. Of course the government could do this at the moment. However only adjustments to the employers' part of the contribution are likely to be effective. If all the contribution came from employers then the government would simply have bigger, (and therefore presumably more effective), numbers to play with. Isitfair believes that this would be a more effective way of dealing with deprivation than the complex Formula Spending Share and Resource Equalisation systems used at present. Unemployment is, after all, along with single parenthood, the main cause of relative deprivation.

In a climate of low inflation any shift towards a payroll tax as a replacement for National Insurance would be fraught with difficulty. Nominal pay, (but not take home pay) would have to be cut to finance the changeover. One can just imagine the outcry from the largely fiscally and economically illiterate British electorate if this were proposed!

2.3.3 Value Added and Other Indirect Taxes

As we remarked in section 4.2.3 of the main document, broadening the tax base for VAT so as to encompass all consumer purchases, would have raised between £35.5Bn and £41.8Bn extra in the financial year 2003/04. However there would appear to be a number of obstacles to doing this. Many people seem to think that the current exemptions, lower rates and so on are somehow justified. However, we would like to question this.

- It is difficult to understand why, (other than for reasons of administrative convenience), there is a lower limit on turnover at which businesses, or the self employed, have to register for VAT. This gives an **economically** unjustifiable advantage to the little man. The social advantage is not clear either. It certainly costs substantial revenue!

- It is somewhat difficult to defend the exemption of children's clothing from VAT - at least on the grounds of "fairness". Children of the same age vary enormously in size - and what is or is not classified as children's clothing for VAT purposes is determined by size. At present many people start paying VAT on their children's clothing much earlier than others. We are aware of some small adults who still pay no VAT - at least on their underwear!

  Any increase in VAT on children's clothing could be offset by an increase in child benefit. The overall effect on revenues is likely to be small but still positive. Much depends upon how much child benefit is paid for each age range of child and how many people currently pay VAT on their clothes at too young or too old an age.

- At one time it was proposed to charge the full rate of VAT on domestic fuel / heating. There is little doubt that this would do more to reduce carbon dioxide emissions than taxing road fuel. The amount of carbon dioxide produced is greater and domestic heating is more price sensitive. There is also no doubt that such a move, on its own, would hit pensioners very hard. However, it is a sad fact of life that if you want to reduce the consumption of something by taxing it then you have to hit those consumers whose budgets are stretched most! The millionaire will simply carry on as before.

  Any increase in VAT on domestic fuel / heating would probably have to be offset by an increase in the basic state pension and / or the winter fuel allowance, (which is really only part of the pension in disguise). This would not negate the effects of the VAT increase on either revenue or the environment - although it would of course reduce them. In the first place only pensioners would benefit. Others would have to pay their full whack. In the second place pensioners would probably choose to spend some of their extra money on things that do not add carbon dioxide to the atmosphere - such as better home insulation or woolly jumpers!

There are many other opportunities for broadening the tax base for VAT. At the moment pornographic books and magazines are exempt! At present, because of the plethora of exemptions, reduced rates and so on, VAT is fiendishly complicated and expensive to administer, (for businesses as well as for government). As noted elsewhere such complexity facilitates avoidance. VAT is also widely evaded, (the cash in hand black economy).

VAT is by no means the only tax on consumer expenditure. We also have excise duties on alcohol, road fuel, tobacco and so on. Unlike VAT these taxes are based on volume not on value. Some of these taxes have now become self defeating. It has been estimated that somewhere between one quarter and one third of all the cigarettes smoked in Britain are smuggled. With lower excise duties, (say equal to those in France), there would be much less smuggling and probably more revenue collected. Similar remarks apply to taxes on alcohol. What could be more economically ridiculous than the "booze cruise"?

Road fuel in Britain is already more highly taxed than it is in most competitor countries. This already causes real commercial problems for hauliers near the channel tunnel and the ferry ports. Any increases in the price of diesel fuel would be economically unwise. In fact, remembering the fairly recent fuel protests, **any** increase in the tax on any road fuel would appear to be asking for trouble.

In view of the foregoing, it seems to be sensible to consider subsuming all excise duties into VAT and raising the same amount as all of the Customs and Excise taxes, (including VAT), do through a single flat rate of VAT applied to **all** purchases. A VAT rate of 19.7% on this basis would allow us to eliminate **all** other sales taxes on consumers! This seems to be "fairer" than demanding that smokers, drinkers, motorists or whatever should finance the rest of us.

Many people might find this approach unattractive believing that we ought to tax "bads" like road fuel, tobacco and alcohol in order to discourage their consumption. The trouble is that taxation is almost totally ineffective in this respect. In days gone by, before the "links" with cancer, global warming or whatever were "established", finance ministers knew that high taxes on petrol, alcohol and tobacco had very little effect on consumption - thereby making them an excellent source of revenue. This still seems to be the case today.

Even the Greens do not claim that road traffic is the largest contributor to Britain's carbon dioxide emissions. They merely claim that "it is the fastest growing contributor" - a point that neatly shows that high taxation on petrol is largely ineffective in reducing consumption. Any half decent economist would have deduced this from the high volatility in oil prices. It takes a huge increase in price to choke off any small excess demand to match small reductions in supply.

In the reference year for establishing our obligations under the Kyoto treaty, land transport including buses, trains and lorries as well as private motor cars accounted for less than 20% of Britain's total carbon dioxide emissions. Since a 20% reduction in carbon dioxide emissions is the target set, even a total ban on the private car would not, on its own, enable us to meet our obligations. Nevertheless, despite the increase in its consumption of (taxed) road fuel, Britain was, until recently, already well on the way to over-fulfilling its Kyoto commitments. This is due partly to the substitution of carbon rich coal by hydrogen rich hydrocarbons in power generation. The only government influence on all this is the removal of coal's preferred status - which is presently being re-instated!

Our reduction in carbon dioxide emissions is also partly due to the collapse of much of our energy intensive manufacturing industry like steel, heavy chemicals, metal bashing and so on. Since we are still consuming products that depend on these industries, all that we have done, in effect, is to “offshore” the production of the associated carbon dioxide by importing these products from abroad. The overall effect on world carbon dioxide emissions is virtually zero.

Classical economic theory would suggest that **all** subsidies or taxes designed to encourage or discourage particular forms of economic activity actually harm the economy. This means that taxing "bads" like road fuel, tobacco or alcohol, or subsidising "goods", like railways, ought to cause real damage. Actually however, taxing road fuel, tobacco and alcohol is not nearly so damaging as classical economic theory would indicate, because these goods have a very low price elasticity of demand. This is what makes taxing them a good source of revenue - and a correspondingly bad way of reducing consumption!

When government excuses the high excise duties it imposes on road fuel, tobacco and alcohol on the ground that these are "bads" and so we should be discouraged from using them, it is being dishonest. The reality of course is that we have high taxes on certain "bads" simply because they are a good way of raising revenue.

Their reasons for congestion charging are also dishonest. There is nothing inherently wrong with road **pricing**. However using it as a way of raising revenue for general purposes would seem a trifle “unfair”. Road users already contribute far more to the exchequer in total than any plausible calculation of the costs to others of their activities - even after including the costs of pollution and the medical costs of road accidents. It is worth remembering that the only people who suffer from congestion, directly or indirectly, are those who cause it directly or indirectly. Using congestion as an excuse for raising revenue which primarily benefits others is simply dishonest.

If local government is to retain any of its responsibilities for highway maintenance, then it seems to be not unreasonable that they should get some form of recompense from those who benefit and / or cause the damage in the first place. We appreciate that since virtually none of the central government's revenue is hypothecated it does not really make any difference where any central government funds for highway maintenance actually come from. We do however believe that part of the Revenue Support Grant or redistributed business rates should be calculated on the basis of the miles of highways to be looked after and the density of traffic using them. Many users of highways are not local.

2.3.4 Business rates

We have already seen in section 2.2 of the main body of the document how the share of business rates in funding local authority expenditure has fallen over recent years. While we can see no logical argument for any particular share being the "right" one, we do consider that, so far as possible, business property should be taxed in exactly the same way as residential property. Obviously this does not man that we should treat the headquarters of Intergalactic Plc as a band H property. We could however make the reasonable claim that it should pay the same amount of tax that a block of flats with the same square footage would be charged. Since we already possess a system which is arguably more or less "fair" in its treatment of different businesses with respect to other businesses, we could use the linkage between offices and flats to arrive at a system which broadly meets the aim of treating residential and business property on an equitable basis. With such a system in place, it would be an easy matter to index business rates to the Council Tax or to whatever form of any property based tax were to replace it, (assuming that something of the sort remains).

The Local Government Association has called for the "repatriation" of business rates. Since the money raised by way of business rates is already redistributed to local authorities, this change, in itself, would not solve the Council Tax problem by raising more money. All that it would do would be to give local authorities more control over their own destinies. However any repatriation would have to be done in a manner that did not reproduce the problems that caused the Conservatives to centralise them in the form of the uniform business rate in the first place.

- Some councils, especially the so-called "loony left" ones, who had a high proportion of businesses within their boundaries, severely overtaxed businesses mainly in order to keep down domestic rates and thereby maintain their grip on power. This tended to drive out the "victim" businesses or send them into bankruptcy. This strategy "worked" since there were rate rebates and benefits for the poor who tended to vote for the left anyway - while the remaining few "rich" tended to move elsewhere. By indexing business rates to the Council Tax, (or vice versa), this particular problem would be avoided.

- Some councils were especially lucky in that they had large enterprises such as a steel works or an oil refinery within their boundaries and were able to offer their residents an exceptionally attractive range of cheap services based on rates collected from those businesses, whilst neighbouring councils, where many of those who actually worked in those large enterprises and actually lived, received nothing.

One possible solution would be to restrict **local** business rates to retail premises. These would include any establishments which deal directly and face to face with the general public such as pubs, restaurants, garages, branch banks, insurance brokers and estate agencies as well as shops. Other enterprises such as offices, factories and so on would continue to have their business rates redistributed as at present.

2.3.5 Inheritance Tax

At first sight Inheritance Tax does not appear to be a particularly attractive candidate to replace any revenue lost from reductions in, (or abolition of), the Council Tax. The budget projections anticipate total revenues of only £3.4Bn from this source for the fiscal year 2005/06. However, this merely reflects the fact that Inheritance Tax is a largely **voluntary** tax - and is often so described. Avoidance is easy - and one suspects that it has been deliberately made so. However, at a conservative estimate, the total value of **England's**, (not the UK's), housing stock is some £3,186Bn. Even if only half of this is ever inherited and even then only every 60 years, (both conservative estimates), then the potential taxable base from Inheritance Tax purely on housing wealth alone is of the order of £26.5Bn per annum! A tax at a rate of 80% on this would yield more than the Council Tax!

For some reason Inheritance Tax now appears to be unpopular. One suspects that this is purely selfishness. It was OK, and even popular, when only a small number of other people's estates were hit. Now that house prices have risen to the point where the many are faced with the prospect of paying the tax for the first time it suddenly becomes "unfair". However, is it "fair" that some people can inherit thousands of acres, whole streets of attractive parts of London, and seats in the House of Lords or on boards of directors when others struggle to afford any sort of home or find a decent job? Inheritance tax at rates close to 100% on all but the tiniest estates would seem to be a "fair" tax. It would help to achieve equality of opportunity, would not involve rewarding the idle and spendthrift at the expense of the hard working and prudent and would, obviously, (since inheritance is always something of a windfall), be directly related to the ability to pay. Such a tax would also remove the anomalies and all the ill feeling associated with paying for care for the elderly. It would no longer matter whether the elderly paid for their care in homes or not. The state would get its dues in the end!

As one possible solution to the pensions crisis, the government has recently floated the idea of reducing the basic state old age pension payable to those who gain from inheritance - especially housing. It would seem to us that it would be much "fairer" if the benefits of inheritance were made available to all and that everybody received a decent state pension, whether they really needed it or not. A beefed up inheritance tax might be a good way to finance this. Instead of the financially unsound "pay as you go" system that we have now, we would be introducing a "pay when you've gone" system. The great advantage is that the pensions would be backed by **real** assets - not paper promises from governments. Obviously, the rate of Inheritance Tax would have to be much the same on all sorts of wealth - otherwise people would simply tend to hold their wealth in the most tax efficient form. Equally, the rates would have to be much the same in all areas - otherwise the elderly might tend to congregate in areas with the lowest rates of Inheritance Tax. This means, in practice, that inheritance taxes would have to be **national** taxes.

3. Reforming benefits

The main criteria for any rational benefits system would seem to be:

- The benefit should actually relieve real hardship or disadvantage at the lowest cost in terms of the consumption of **real** economic resources.

  - Many benefits don't do much for the intended recipients. The main beneficiaries turn out to be somebody else. For example housing benefit does more to benefit landlords than it does to benefit the impoverished. It simply increases rents. Indeed, where there is a real shortage of housing, (as there is in some parts of the country), housing benefit does nothing for the homeless. All it does is shuffle the homeless around so that one lot of people who were previously homeless are housed whereas another group of people who were previously housed become homeless in order to make way for them. In a similar way the CAP benefits landowners more than it does farmers. Indeed this seems to be a common problem with **targeted** benefits.

  - Economic cost is not the same as accounting cost. Economic cost is simply the reduction in output that occurs as a result of the benefit and the real resources involved in administration, (i.e. the time of the administrators which could potentially be devoted to something more useful). Most benefits reduce incentives for both the recipients and those who provide the funds. This will normally lead to some loss in their economic output. This loss needs to be made as small as possible. Accounting costs, like economic costs include the costs of administration as well as including the amount of any monies redistributed. Accounting costs are usually much larger than economic costs.

- The benefit should be easy to claim by those entitled to receive it.

  - At present this is not the case for many benefits. For example it has been estimated that about a million people who are entitled to claim Council Tax Benefit fail to do so because of its complexity. This certainly reduces the **accounting** cost of the benefit but probably not the economic cost. It certainly does little to relieve the hardships and disadvantages which it was designed to alleviate.

- Entitlement to benefit should not make people better off than those not entitled to claim and certainly not better off than those whose taxes pay for it.

- Benefits should not encourage those types of behaviour the consequences of which they are designed to alleviate.

  - In one sense unemployment benefit could be regarded as payment for being unemployed. As such it is clearly a subsidy. Generally governments use subsidies to encourage particular types of activity. Do any governments really want to encourage unemployment? Numerous specific / targeted benefits fall into this trap.

- Benefits should not create "poverty traps"

    — So-called "poverty traps", i.e. the situation that arises when someone is actually better off not earning or increasing his / her earned income, almost always arise as the malignant combination of means testing, (which leads to withdrawal of benefits), and multiple benefit sources, (which means that more than one benefit gets withdrawn at the same time). Most benefit withdrawals or taper relief assume that only that particular single benefit is being claimed, (if they didn't do this there would be real hardship involved if it were actually the case). Multiple benefits normally arise because benefits are targeted at particular items of expenditure such as rent or Council Tax.

These considerations force us to two conclusions:

- Benefits should be addressed towards supplementing income rather than towards subsidising (specific) expenditures.

    — Relieves hardship and disadvantages

    — Benefits the intended recipient rather than someone else

    — Prevents poverty traps

- Benefits should not be means tested or circumstance tested

    — Minimises economic costs, (but often increases accounting costs)

    — Avoids encouraging inappropriate behaviour, (e.g. subsidising / encouraging unemployment)

    — Ensures that people not on benefits or who pay for benefits are not worse of than those that receive benefits

    — Easy to claim. If everyone is entitled then there is no need to check or fill in forms.

    — Prevents poverty traps

Taken together, these conditions point towards what is essentially a flat rate benefit system. In such a system everyone would receive a sort of "citizen's income", payable to all citizens from birth until death at a rate dependent only on their age. This is manifestly "fair" since over a full lifetime, every citizen would receive much the same amount from the common pool. There would be no means tested or circumstance tested benefits whatever. A simple "Citizen's Income", could subsume child benefit, old age pensions, unemployment benefit, income supplement, personal allowance, married person's allowance and so on. This would much simpler and cheaper to administer the present over-complex system of multiple benefits.

We doubt whether **any** targeted means tested benefit, however complex, (and simplicity is surely a virtue), can possibly deal with the manifold relevant factors in a totally “fair” and non-discriminatory manner. There are always anomalies and unintended consequences leading to poverty traps and the like. This is especially the case when there are many different benefits and taxes involved. Means tested benefits also tend to encourage the very behaviour whose consequences they are set up to relieve.

A means test is a mean and demeaning test.

Means tests only reduce accounting costs. They do not reduce economic costs. In fact they tend to increase them! Transfer payments that the recipient receives as a basic right have the lowest economic costs of all.

If old age pensions, which are a pure transfer payment, were to increase in line with the same index as local authority costs, (or even in line with some new Council Tax index!), then much of the furore about Council Tax rises, and indeed much of the real hardship, would disappear. Council Tax Benefit is NOT the answer.

The main reason why people in the UK get paid so much more than those in places like India for doing essentially the same jobs is past investment and innovation, (in institutional arrangements as well as physical capital, infrastructure or technology). Although most of this investment and innovation has been made by people who are now dead, it is obvious that, amongst the living, the age group that must have contributed the most are those who have worked longest - i.e. the pensioners. Pensioners have a better **moral right** to share in the benefits of any increased GDP per head than any other age group.

However, simply paying pensioners properly, (which we definitely **would** advocate), only relieves the problems associated with pensioners. As we have already shown, there are other groups who are also badly affected by the Council Tax.. We do not believe that tinkering with the benefits system will **ever** provide a satisfactory answer. The Council Tax is too flawed for that. Reform, in the end, will be unavoidable.

4. Combining tax and benefit reforms

We have made the case for both a flat rate income tax system and a flat rate universal non means tested benefit system. The case for each of them is a strong one on its own. However, taken together, the case for a flat rate income tax regime **coupled with** a flat rate “citizen’s income” approach offers significant extra benefits when compared with what each does alone.

The benefits arising from such a combined approach would be substantial: poverty traps would be a thing of the past; the number of officials, and the corresponding costs, necessary to administer and police the tax and benefits systems would be much reduced; all work, however marginal or lowly paid, would be profitable to undertake - enabling those able in mind or body to contribute to society instead of being thrown on the scrap heap. Unemployment would virtually disappear, (providing of course that job destroying minimum wage legislation were repealed at the same time). However the biggest benefit of such a system is that it is politically neutral: extreme egalitarians could have very high rates of income tax coupled with high rates of Citizen’s Income, whilst extreme incentivists could have low rates of income tax and low rates of Citizen’s Income.

5. Reforming the relationship between local and central government

Any proposals for the reform of the relationship between central and local government needs to begin by addressing the question of what local government is really **for**. Is the purpose of local government simply to manage, (the **how**), local services or is it to prioritise and choose which services to offer, (the **what**)? If the answer is **management**, then there is little point in either local elections or local democracy. The history of elected management is pretty discouraging, (look at what happened to the Co-op and compare this with the performance of the supermarket chains). One can always use the tools common in industrial conglomerates to bring management to account in terms of **efficiency**. If this is the purpose of local government, then there is no real point in local taxation. Distribution of funds collected by central government in line with locally prepared budgets using management ratios would work just as well in local government as it does in industrial conglomerates.

On the other hand if local government is expected to **choose**, then one of the choices that they must be allowed to make is between high tax and high spending on the one hand and lower tax and lower spending on the other. This is not something that central government can choose for them. It is something where local democracy is **vital**. Unfortunately if we mix up management with policy, we tend to get the worst of both worlds. If central government funds are mixed up with local funds then local taxation becomes a myth. All that we have is locally **collected** tax but not locally **determined** tax. Central government can always adjust its portion of the funding so as to make a choice of how much tax to raise locally irrelevant to the services that can be delivered..

5.1 Ensuring local accountability

There are really only three basic approaches to **clarifying** the muddle surrounding **who**, (i.e. central government or local government), is responsible for **what**. Without this clarification there is very little **accountability**. The three basic approaches available are:

- **Basic approach 1** - Central government collects all the taxes for local services and distributes the resulting funds according to some measure of "need"

    — This would make it absolutely clear who was responsible for any underfunding or waste and put accountability where it belongs - with central government in this instance.

    Unfortunately, under any arrangement of this sort, if local people or local councils were to have any say at all they would have a perverse incentive to inflate their budgets / statements of need in competition with others. As a local you would get all the benefit but only part of the costs - unless others play the game as well as, or better than, you do. This is likely to lead to local profligacy - and higher taxes overall. It is probably no accident that in a recent report the Audit Commission said: "We found that increases tend to be higher in authorities that are not directly elected – 13 of the 20 highest increases in Council Tax were agreed by police authorities."

One would suspect that the reason that unelected bodies are responsible for the largest Council Tax precepts is that they have no real accountability. They do not collect the taxes and can not be dismissed when the taxpayers find the corresponding tax bills too high. This solution really does remove local accountability. If all taxes were set and collected centrally, then it would only be possible to demonstrate that local authorities **in general** are overspending. It would not be possible to see **which ones** are.

- **Basic approach 2** - Local government collects all the taxes for local services and decides how the proceeds should be spent

  — Once again this would make it absolutely clear who was responsible for any underfunding or waste and put accountability where it belongs - with local government in this instance.

  Unfortunately under any arrangement of this sort local taxes would have to increase quite sharply. The increases would be largest in those local authority areas which currently receive the largest subventions from central government. Although it is not always the case, the size of these subventions is often driven by genuine need or social deprivation.

- **Basic approach 3** - Local government sets a local tax rate and central government provides additional funds to local authorities according to some multiplier of local taxes. Local government would decide on all local spending priorities. The multiplier could be different for different local authorities according to some measure of "need"

  — In this situation accountability would belong with local government. However, unless the multiplier could be varied, there would be little accountability to the general, non-local taxpayer who would be providing the additional funds.

  Unfortunately if the multiplier could be varied, there would be a real and perverse incentive for central government to manipulate this multiplier for political purposes. (Many people believe that this already happens under the existing FSS and Resource Equalisation systems).

  On the other hand, if the local multiplier were fixed, then those local authorities which raised the smallest proportion of total expenditure locally would have an incentive towards extravagance - particularly if they could return much of the locally raised money to their electorates in cash or near-cash forms, (e.g. in vouchers). This problem would also be exacerbated if much of the locally raised tax were actually paid for by a specifically targeted benefit - like CTB!

From the above it is clear that none of the basic solutions is ideal. What we need is some sort of hybrid. The existing Council Tax system is, of course, a hybrid - but a peculiarly bad one! Currently, central government provides, on average, 75% of local authority funding, and dictates up to 80% of local authority expenditure. The local taxpayer is simply presented with a bill and is required, by law to pay it. In reality local government is almost totally dictated to by central government. There is very little local accountability. Central government can, (and maybe does), use redistribution for gerrymandering and party political ends.

There are some fundamental problems associated with any system that is reliant on central government grants. These become more apparent the larger the proportion of total expenditure financed by central government becomes. The extreme case would be where the government collected all the funds and decided what should be done with them, (basic approach 1).

- It is obvious that the greater the proportion of local expenditure that is funded by central government then the greater is the scope for redistribution.. Areas which meet with central government approval, (perhaps because they vote the "right" way), can always be subsidised by other areas.

- Local authorities tend to become less efficient It is true that councils are required under the 1999 Local Government Act to deliver continuous improvement through the application of best value, including the identification of savings through more economic, efficient and effective ways of delivering services. However this seems to be a law more honoured in the breach than in the observance! To rely on a law of this sort when removing some of the sanctions on inefficiency looks to be optimistic in the extreme! Most of those who have worked with both public and private sectors believe that there is enormous scope for efficiency savings in the former.

- Whenever there are problems with the national finances, central government can simply reduce the amount that they give to local government. This is particularly tempting when there is an elected local authority in a position to take any flak. "Ring fencing" specific central taxes for local government is not really much of an answer to this.

    — Ring fencing (hypothecating taxes) is really an illusion. When new taxes are introduced they are often presented as though they are hypothecated to something of which the taxpayer will approve in order to soften the blow. However such hypothecation rarely survives. As long as the majority of taxes are unhypothecated, hypothecation itself is really an illusion. The government can always divert general taxes that would have been spent on the hypothecated activity to other purposes, (look at what they have done with respect to funds from the national lottery). Only when the total take from the supposedly hypothecated tax exceeds the amount spent on the service, (for example: roads and the taxes on motorists; NHS expenditure on smoking related diseases and tobacco tax), to which it is hypothecated, is the hypocrisy of the government clear for all to see.

    The only ring fencing mechanism that is bound to work is when:

    - Those who spend the taxes also collect them

    - Those who collect and spend these taxes have no other responsibilities. Central government does not tell them what services they must provide

    - Those who collect and spend these taxes receive no subventions or funding from any other source, nor do they have to pass on any of the revenue raised to anyone else.

    There is no reason why, in the interests of savings in collection costs, local authorities should not band together to collect, on a central basis, any taxes designed to replace the council tax.

It would seem that the best hybrid solution is one with a better match between power and responsibility - something that is woefully lacking in the current system. Currently councils can afford to be profligate and can then twist the central government's arm to increase the amount that central government provides. Equally, central government can dictate to local authorities what services they must provide and yet fail to give them the funds with which to discharge those responsibilities. If councils and central government were entirely separate, with separate and well defined responsibilities and separate sources of funds, then councils would have to **manage** and fund **their** decisions and central government would have to do likewise. In such a situation central government would be responsible for funding and **managing** all "essential" services. Local people could be represented through elected advisory bodies, (as used to happen in Hong Kong - where it worked well), which would be quite separate from the local council. However it would be central government that would have the final say. Local government would be responsible for providing all those little "extras" that make communities what they are. At one extreme they could even do nothing and spend nothing- if that is what the local electorate wanted!

There will always be a requirement for local input. Central government can not provide this. An advisory body and a separate executive body would appear to be the way forward. The executive body could then make local choices and decisions. Some increases in local spending are desirable but the choice about whether those are to be met by reducing spending on other services, increasing charges or increasing local taxes are decisions elected local councils should make.

5.2 Improving the balance of funding

Given that currently central government dictates around 80% of local authority spending, it would seem appropriate that, in fiscal terms, local government responsibilities for management and finances should be reduced to something like 20% of what they are now. On average, this would reduce locally funded taxation by about 20%.

> *At present for every £100 spent by local government only £20 is discretionary spend so far as local government is concerned. On the other hand, local government is expected to raise around £25 for every £100 of total spending. This £5 really "ought" to be funded by central government - he who calls the tune should pay the piper. On average therefore local authorities would only have to raise 20/25ths of the revenue that they do now - a reduction of 20%.*

An average reduction of around this magnitude would do much to defuse the ill feeling surrounding Council Tax. Isitfair really wants more than this - but at least it would be a start.

We appreciate that some areas of the country would do badly out of such a change. However, we do not believe that it is "fair" to ask **local** taxpayers of richer regions to finance other areas. Not everyone in the richer areas is himself rich! Why should somebody be asked to pay higher taxes simply because his neighbour is richer than he is himself? If people are on average richer in certain areas, (as in monetary terms they are), they already make a greater contribution than others through income tax and VAT. No doubt they would be asked to contribute even more, (as would the richer people in poorer areas), if central government were to maintain the level of support to the poorer areas that they currently provide, (as, at least initially, they probably should). However we note that much of the apparent extra prosperity of certain regions has more to do with the cost of living than it does with purchasing power. In a sense the UK is already experiencing some of the problems of a single currency, (in this case the pound), applied over a non-optimal area.