Balance of Funding Review – Report

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July 2004

The Balance of Funding Review was set up by the Government, but this report is not a statement of Government policy.

The views and opinions expressed in this report do not necessarily reflect those of the Office of the Deputy Prime Minister or of the Government as a whole.

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Summary and Conclusions

Headlines

- **A shift in the balance of central and local funding of local government would give local authorities more funding flexibility by reducing the impact of the gearing problem on their decisions about council tax levels. Gearing can cloud the accountability and transparency of local spending decisions and can contribute to unsustainable council tax increases.**

- **There are therefore strong arguments for shifting the balance of funding towards more local funding, but this depends on the feasibility and desirability of any measures which might be used to achieve it.**

- **There is ultimately a trade-off between raising a greater proportion of revenue locally and levels of equalisation between different council areas. However, it is possible to shift the balance of funding towards greater local revenue raising whilst still maintaining current levels of equalisation. The extent to which this is possible would depend on the precise form of local revenue raising. Any option chosen would also involve a trade-off between the simplicity of the measure and equity.**

- **Council tax should be retained but reformed. It has important advantages as a local tax; for example, the yield is predictable and there is a high collection rate. However, it will need reform to address its impact on those on low incomes and the impact of revaluation. Further work will be needed on the options for such reform. A fair and effective system of Council Tax Benefit (CTB) will be a vital component of a reformed council tax package. Improvements to CTB and measures to improve take-up need not wait for structural reform of council tax.**

- **The only way identified by the Review to achieve a major shift in the balance of funding is supplementing a reformed council tax with either re-localised business rates or a local income tax (LIT) or a combination of both. None of these options would be easy and further work would be required. In keeping with the approach adopted throughout the Review, the aim should be to avoid significant changes to the overall liabilities of taxpayers.**

- **Re-localisation of business rates could give councils greater incentives to promote economic development and improve links with business. However, business has serious concerns, including potential risks to their productivity and competitiveness. They argue that it would mean an end to a single national rate and would be likely to harm relationships between business and local government.**

- **A LIT would be more progressive than council tax and it would also be more buoyant (but less predictable as a result). If a form of LIT were to be pursued as a supplement to council tax, there would be strong arguments in favour of a simpler, rather than a more complex, model, but only so far as this was**

consistent with equity between individuals. However, considerable further work would be required to address the substantial technical and administrative issues and costs associated with a LIT as well as the impact on individuals and employers before firm conclusions could be reached on the feasibility or desirability of a LIT.

- **Smaller taxes or charges do not provide the potential for major change in the balance of funding. The case for and against each such option should be judged on its own merits.**

Introduction

1 The Government wants to see more effective and more accountable local government and the local government finance system is an essential part of that. This report is a contribution to the important and continuing debate about this. It sets out the conclusions of the Balance of Funding Review which took place between April 2003 and July 2004. It considers the arguments for and against changing the way in which local authorities in England are funded. It sets out options, not a recommended solution.

2 The Government set up the Review in response to local government concerns that the present balance of funding was a problem. It had been argued that it undermined local authority accountability and gave rise to the 'gearing problem' (see paragraph 8). The overall aim of the Review was to look at all aspects of the balance of funding, review the evidence and consider reform options, setting out the pros and cons of each. Its aim was not to consider ways of increasing local government revenue, but rather to examine the case for changing the balance of funding between central and local sources, which is currently about 75% central to 25% local.

3 Even during the course of the Review the focus of debate shifted beyond the balance of funding, narrowly defined, towards detailed debate about council tax and possible alternatives, and our work reflected that shift. The Review has been conducted for the Government, not by the Government. It follows that this report is not a statement of Government policy. It is rather an analysis of issues and options. Although it draws some conclusions, in line with its remit it does not make recommendations. It is submitted for consideration by the Government – and indeed by all who are interested in local government finance. The Review Steering Group hope that it will help to inform the decisions that need to be made about the future system.

4 Nor is it the last word on the subject. Local government finance is a huge and highly complex area. To keep the Review manageable, we had to be selective about what it considered. For example, it has not looked at the working of the Revenue Support Grant (RSG) system which was reviewed in 2002. Nevertheless, the report does highlight a number of the most important issues and of the key choices that need to be made.

5 The wide range of views held across a Group such as ours, as well as the complexity of many areas we examined, mean that we never aimed to achieve unanimity on every detail we looked at. Such an approach would have hindered our work rather than helped it. But nor was it called for given the nature of our task and our wish, not to provide a detailed blueprint for reform, but to gain consensus at this stage of the argument on the broad issues, and to agree what the most likely options were, as the

basis for more detailed work in the future. However, we should point out that, given the nature of the Group and its work, the findings of the Review do not necessarily reflect the views of individual Steering Group members.

6 Finally, we noted that our Review was not being undertaken in isolation. While we were asked to consider only some of the issues relevant to financing local government and its funding, a great deal of other work is going on elsewhere on other matters, many of them highly relevant. The way forward clearly needs to take full account of all these strands.

Is the balance of funding really a problem?

7 Responses to the Review's public consultation show that the public generally have little interest in the issue of the balance of funding itself. This lack of interest could be explained partially by a lack of understanding, as demonstrated by focus group research commissioned by the Review, which found that most people knew little about the balance of funding. When asked to guess, most assumed that councils raised 70-80% of their funding locally through council tax. They were surprised to learn the true position, but claimed that it did not matter much provided that there were effective checks and balances on the way the money was spent.

8 However, whilst the public might not be directly concerned by the balance of funding, they are certainly concerned about rates of increase in council tax to which the balance of funding is related, because of the magnifying effect of 'gearing'. This is the term used to express the fact that a given percentage increase in local authority spending budgets will require a larger percentage increase in council tax. Local authorities' dependence on Government grant means that for every 1% increase in spending they need, on average, to increase council tax by 4%, a 'gearing ratio' of 4:1. There is, however, a wide variation in gearing across individual authorities which varies from around 2:1 in authorities with the largest council tax bases to 9:1 or more in authorities with the smallest taxbases (which tend to be those with the highest needs). Because of the gearing effect, comparatively small spending pressures can lead to some big increases in council tax for individual taxpayers. For many, gearing is at the heart of the problem with the current balance of funding. Changing the balance of funding in favour of more locally raised revenues would reduce gearing across the board and improve funding flexibility, allowing local authorities to vary spending levels and fund additional pressures with smaller percentage increases in council tax. However, whilst it would ease the difficulty, it could not remove it altogether.

9 Research designed to test whether there were any links between balance of funding on the one hand and election turnout and efficiency on the other found that the available evidence did not demonstrate a direct connection with the former and only a weak relationship with the latter. However, the consultation confirmed a strong concern about the status quo on the part of local authorities. Clearly gearing in particular is seen as a major difficulty by many authorities. It can cloud the accountability and transparency of local spending decisions and can contribute to unsustainable council tax increases. However, some commentators argue that the gearing effect increases the visibility to taxpayers and the electorate of council tax rises and spending changes.

10 There is, moreover, a question of principle about whether it is right for local authorities to be so dependent on central government grant. How far can authorities be properly

accountable to their taxpayers with the current balance of funding? How far can transparency in local spending decisions be achieved to allow local people to see more clearly the link between taxation and spending? Indeed, when considering the balance of funding more closely, we found that we were actually looking at a range of problems, rather than a simple issue.

11 We concluded that there are strong arguments in favour of a shift in the balance of funding, but the case for any shift depends on the feasibility and desirability of any measures which might be used to achieve it.

12 There is ultimately a trade-off between raising a greater proportion of revenue locally and levels of equalisation between different council areas. However, it is possible to shift the balance of funding towards greater local revenue raising whilst still maintaining current levels of equalisation. The extent to which this is possible would depend on the precise form of local revenue raising. Any option chosen would also involve a trade-off between the simplicity of the measure and equity.

13 The four main reform options put forward during the public consultation are considered below (see paragraph 16 onwards).

Principles/criteria

14 We adopted the following key principles and used them as criteria when considering reform options:

- the potential impact on the balance of funding: how far each option could be used to effect a significant shift in the present balance;
- local accountability: how far an option would alter local authorities' accountability to their electorate and taxpayers and improve the transparency of local spending decisions;
- progessivity and fairness: how far each tax option would relate to taxpayers' relative wealth and income;
- evenness of distribution: how significantly the taxbase of each option would vary between different areas, and the degree to which it would require equalisation;
- buoyancy: how far the revenues from each option would rise in line with economic growth;
- predictability: how far each option would yield a predictable revenue stream in a particular financial year or from year to year;
- collectability/administrative ease: how far each option would yield a tax that was easy to collect and cost-effective.

15 A number of other important principles and criteria were raised in discussion. These too would need to be considered in developing any further proposals for reform of the local government finance system. These include incentives to improve effectiveness and efficiency in local government, as well as the implications for the Government's macroeconomic policy.

Reform of council tax

16 On its introduction council tax was widely accepted. Its benefits are that:

- it is the only tax on residential property values (and property taxes are widely used in other countries);
- it is an existing tax under the control of local government;
- the basic principles are easy to understand;
- it is easy to collect – in England in 2003-4 96.5% of council tax for that year was collected in-year; ultimate collection rates are even higher;
- the yield is easy to predict.

17 More recently, some concerns about council tax have been voiced, for example that it is:

- regressive and bears more heavily on those on low incomes, especially if they live in higher band properties;
- not 'buoyant' i.e. revenue does not rise as the economy grows.

18 The Government is committed to revaluing properties for council tax purposes on the basis of 2005 property values. The new values will then be used as the basis for bills from 1 April 2007 onwards. The policy is that the total yield from the council tax will not increase as a result of the revaluation. Analysis presented to the Review by the New Policy Institute (NPI) showed that, unless the council tax system is reformed, revaluation will mean that the tax burden will be decreased in areas with lower than average increases in house prices since 1991 and increased in areas with above average increases. This could mean very large increases for some people on low incomes living in high value properties. People living in the lowest value properties would not be able to gain whilst those living in the highest value properties would be protected.

19 Responses to the Review's public consultation showed a range of views on whether council tax should be reformed or abolished, and what revenue sources should supplement or replace it. However, many respondents favoured reform.

20 NPI presented detailed evidence on possible reform of council tax. Their analysis strongly suggested that revaluation based on the present structure of council tax would be difficult to defend because of the consequences of differential house price movements in different parts of the country. Some reform of council tax would be required at the same time. In particular, NPI suggested the need to consider changes to the banding structure and to the ratios between bands to deal with the problem of regressivity. They also suggested that consideration be given to a sub-national approach to spread out the pattern of winners and losers. Finally, they flagged the need to ensure that CTB was able to play its full part in ensuring that a future council tax system was fair and acceptable.

21 Our main conclusions on council tax are as follows:

- council tax has important advantages. There is a strong economic case for a tax based on property; council tax should be retained but reformed;

- there is not always a strong link between people's income and the value of their property and council tax is therefore, especially in its current form (given poor take-up of CTB), regressive to income;
- there is a clear case for reviewing council tax bands and the ratios between them at the time of revaluation. However, particular care is needed to ensure that council taxpayers on low incomes living in high value properties are not unfairly affected;
- the detailed case for and against some kind of sub-national approach should be considered. Again, further work is needed to determine the best solution, taking account of possible 'cliff edge' problems. The case for a sub-national approach may be weaker if the national divergence in property prices continues to close;
- a fair and effective system of CTB is essential to the continued acceptability of council tax. Take-up needs to be improved and NPI's proposals for changing the savings limit and transforming CTB from a means tested benefit into a maximum liability scheme should be examined seriously. Improvements to CTB and measures to improve take-up need not wait for structural reform of council tax;
- it would be difficult to change the present balance of funding by raising a significantly higher proportion of local funding through council tax even if it were reformed;
- in short, further detailed work is now required on how council tax might be reformed, based on a clear vision of the direction of travel.

Reform of business rates

22 Since 1990/91 national non-domestic rates (also known as 'business rates'), though collected by local authorities, have been paid into a central pool and redistributed by central government to authorities on a per capita basis. Annual increases in the rate are limited by statute to inflation. The Review's public consultation revealed a clear divergence of views between local authorities who almost all wanted re-localisation of business rates and the business community who were opposed.

23 Some responses acknowledged that the amount of business rates that local authorities could raise differs hugely – for example, Westminster Council alone raises 6% of the total – more than Liverpool, Manchester, Newcastle and Birmingham combined. Careful thought would need to be given to how to equalise resources under a localised business rate system (although equalisation was a feature of the previous localised system).

24 We invited further evidence from the Local Government Association (LGA) and the Confederation of British Industry (CBI). The LGA's case in favour of re-localisation rested on the following main points:

- as a result of the inflation cap on annual increases, the share of local government funding paid by business had gone down. In 1990/91 business rates accounted for 29% of council expenditure. By 2003/04 this had fallen to 22%. In the 2004/05 RSG settlement it was 20.4%;
- localisation would encourage more effective partnerships between councils and business than the present system;

- localisation would improve the balance of funding (to about 50% local), which would reduce gearing and increase accountability.

25 The LGA pointed to evidence that there was a trade-off between rents and other property costs including rates. However, they acknowledged that, if business rates were re-localised, there would have to be safeguards for business to prevent councils arbitrarily raising the rates. The LGA also acknowledged that some equalisation would be needed because the amount of business rates that individual local authorities could raise differed hugely.

26 Business opposed re-localisation because:

- in their view, locally set business rates had not worked before 1991. Business had put effort into consultation with authorities over setting rate levels, but their input had been time-consuming and costly and had had little impact. This had damaged the relationship between them;
- the current system protected business against unaffordable rate increases and eased forward planning. A local business rate could lead to councils simply increasing business rates, as had happened before 1991, in order to reduce pressure on council tax bills. There would also be arbitrary and unpredictable local variations in bills that would mean an end to a single national rate and again would be likely to harm relationships between business and local government;
- business also had concerns about possible risks to their productivity and competitiveness.

27 Business acknowledged that the proportion of local funding met through business rates had fallen. But they emphasised that they also contributed to local government through national taxation, which was then distributed to authorities as central grant. Any future assessment of proposals for business rates reform must be assessed against the criteria of the impact on economic competitiveness, business costs and the full picture of the national tax burden on business.

28 We accept that there are strongly held views on either side of the argument for re-localisation. We also note that there are various intermediate options. The options for change, which would have differing potential impacts on the balance of funding, are as follows:

- re-localise with safeguards for business e.g. linking maximum increases to council tax increases;
- retain the national system, but lift the current inflation cap on rates increases;
- retain the national system, but allow an element of local retention of rates, building on the Local Authority Business Growth Incentives scheme and the existing powers for Business Improvement Districts.

A local income tax

29 The Review's public consultation revealed much support for some kind of LIT. However, LIT could take a number of different possible forms, each with its own implications for local authorities and individuals. In particular, it could be *variable or assigned*, and it could *supplement or replace* council tax. (An assigned tax would

involve the assignment to local authorities of a set proportion of national income tax receipts. Local authorities would not have power to vary the rate of tax and hence would have no direct control over the amount they were allocated.)

30 The Chartered Institute of Public Finance and Accountancy (CIPFA) gave evidence to the Review raising a number of the detailed technical issues which needed to be resolved. In doing so they concentrated on a variable LIT, both because an assigned tax would arguably not be a 'local' tax, and because it is in seeking to give local authorities the powers to vary tax rates that the key technical challenges present themselves.

31 CIPFA's analysis clearly confirmed our understanding that consideration of the case for a LIT raised a wide range of fundamental and, in many cases, difficult issues. These ranged from who would collect the tax, how much it would cost to introduce and run, and what the burden on employers would be, to what forms of income might be taxed, and at what rate – as well, of course, as what the effect of the tax would be for individual tax payers.

32 Taking into account these issues, CIPFA presented one 'possible model' of a relatively simple form of local income tax, which would supplement, not replace, the council tax and be restricted to larger, multi-purpose authorities. This is described in detail in Chapter 5.

33 In the light of CIPFA's advice, we have reached the following main conclusions:

- an assigned LIT would not achieve any shift in the balance of funding although it would improve buoyancy (but at the cost of predictability and equalisation) and might provide a stepping stone to a variable LIT if such an option were to prove feasible and desirable;
- as noted above, council tax has important advantages and there is a strong case for retaining it, subject to detailed consideration of options for reforming it. Any further work examining the pros and cons of LIT should proceed on the basis that it is a supplement to, not a replacement for, council tax. At any rate, simply replacing council tax with a LIT would not in itself shift the balance of funding;
- a supplementary LIT would be progressive to income and provide a buoyant yield and is capable of shifting the balance of funding significantly;
- a variable LIT should increase local accountability, subject to the important rider that, unless clearly presented and explained, a more complex funding system might be harder for taxpayers to understand;
- the effects of any LIT on individuals or employers would also need to be examined with great care. There are a number of potentially serious risks and disadvantages that would need to be considered in detail, including the potential additional costs that the system could impose;
- LIT could be potentially complex to administer. CIPFA's work set out a relatively simple form of LIT, although in practice there may be a trade-off between simplicity on the one hand and equity on the other;
- building on CIPFA's work, considerable further work would be required to address the significant technical and administrative difficulties associated with LIT, including the burden on employers, before firm conclusions could be reached on its feasibility or desirability.

Other options

34 Responses to the Review consultation suggested a number of possibilities for smaller taxes and charges. We invited the LGA to present further evidence on the following:

- localised Vehicle Excise Duty (VED), either as an assigned revenue or administered locally;
- localised Stamp Duty on property transfers;
- local sales tax, levied on all goods, either as a replacement for, or supplement to, VAT, or on specified goods;
- land value tax, levied on the site value of land, either replacing or combining existing property taxes;
- tourist bed tax, levied per night spent in accommodation;
- green taxes, such as a plastic bag tax;
- charging for services, such as waste;
- charges for utilities' street works;
- road user charging, such as congestion charging and workplace parking levies.

35 In some cases charging powers already exist (e.g. congestion charging), but most of the above options would require legislation.

36 We decided not to pursue most of these possibilities, but asked the LGA to do further work on VED and tourist bed taxes. The LGA suggested giving local authorities an incentive to deal with the problem of abandoned and unlicensed cars by allowing them to retain some VED revenues locally. They also suggested the possibility of introducing optional tourist taxes; it would be open to authorities who adopted such a tax to use the proceeds to help pay for tourist promotion following local consultation about the tax rate. Such initiatives, it was argued, had potential policy benefits and would encourage authorities to talk to local people about local issues.

37 We have concluded that none of the taxes looked at could achieve a significant shift in the balance of funding. The case for and against any of these options should be judged on its own merits rather than on any impact it may make on the balance of funding.

Combination option

38 The choice does not necessarily need to be confined to pursuing just one of the above options. Indeed the LGA suggested a combination option which was set out in a paper for the Review.[1] They argued that local government would benefit from a diversity of local sources of income, not as a means of increasing the totality of resources, but as a means of shifting the balance of funding. The model combined a reformed domestic property tax with a progressive re-localisation of business rates, a form of LIT and one or more smaller taxes/charges, without increasing the overall tax burden. The LGA considered that such a combination would both shift the balance of funding and enable

1 BoF 21: The Balance of Funding – A Combination Option. This and other BoF papers referred to in subsequent footnotes can be found at http://www.local.odpm.gov.uk/finance/balance.htm

the property tax to bear less of the burden than at present, without reaching the limits of the equalisation system. Their paper suggested that the balance of funding could be reversed (to about 75:25), whilst still maintaining equalisation for the vast majority of authorities, although this would need to be tested carefully with detailed modelling at individual authority level.

39 There might be advantages in the principle of a combination option beyond those of its individual constituents, although a combination option would, other things being equal, cost more to administer than a single tax option. While there would be advantages to local authorities from having a more diverse local revenue base, the case for the combination option would depend on the pros and cons of the individual taxes proposed.

40 If such an option were pursued, careful consideration would need to be given to the timetable for reform, and whether it would better to introduce the elements of a combination reform package at the same time as, or as part of, a process of gradual change.

Chapter 1
Background and Remit of the Review

Background

1.1 The origin of the Review lies in the White Paper *Strong Local Leadership – Quality Public Services* published by the then Department for Transport, Local Government and the Regions in December 2001.

1.2 The White Paper noted that it was often argued that the current balance between national and local taxes had an adverse impact on local authorities' autonomy. However, there was little hard evidence for or against that view. Nor was there consensus on how the balance might be shifted. The main reason why local authorities were concerned about the balance of funding was that it gave rise to the gearing problem (see paragraph 1.20).

1.3 The Government believed that the balance of control was a more pressing issue than the balance of funding and promised to keep ring-fencing of grant under review with the aim of removing it as soon as possible.

1.4 It did not think that there were any quick or easy ways of securing a major shift in the balance of funding. However, there was a need to be clear about what the longer-term reform options were and whether there were more modest options that could be pursued more quickly.

1.5 The Government therefore promised that, once it had done some further analysis, it would establish a high-level working group involving Ministers and senior figures from local government to look at the balance of funding, reviewing the evidence and looking at reform options.

Terms of reference

1.6 The Minister for Local and Regional Government announced the following terms of reference for the Review on 20 January 2003:

The overall aim is to review all aspects of the balance of funding, review the evidence and look at reform options. This can be broken down into two objectives:

1. Establishing the nature and priority of the issue

The review will explore and test the range of criticisms that have been levelled at the present balance of funding, in order to establish clearly the key issues and as far as possible to clarify causalities. It will also examine the extent of impact on different authorities. A better understanding of the inter-related issues should shed light on the case for change, and influence how potential options for change are appraised.

2. Identifying and analysing options for change

The review will consider a range of short and long term options for changing the current balance of funding. Through a wide-ranging and objective analysis it will establish the 'pros and cons' of each option. The review should take a broad look at the full impact of each option so that all the implications can be established.

To achieve these objectives we intend to make full use of existing evidence, and to conduct research where necessary.

The Steering Group

1.7 On 4 April 2003 the Minister for Local and Regional Government announced the members of the Review Steering Group which he would chair. The Steering Group brought together representatives of local and central government, business, the unions and other experts. A list of members is at Annex A.

1.8 We met for the first time on 28 April 2003 and had nine meetings in all. In our first three meetings we discussed the data and issues which formed the starting point for the review, as well as principles of a sustainable local government finance system. We also commissioned and considered the results of a public consultation and independent research. The next three meetings focussed mainly on possible reform options and the remaining meetings were concerned with the preparation of this report.

The background data for the Review

1.9 Annex B sets out the basic data which provided the background to the Review.

Research for the Review

1.10 At our first meeting, we agreed that there was a need for some research to fill gaps in the evidence base. We therefore commissioned research projects on:

- the connection between the balance of funding level, voter turnout, and local authority spending decisions;
- public awareness and attitudes to the financing of local government and its impact on perceptions of service quality, accountability and participation;
- the relationship between the balance of funding and efficiency; and
- international lessons.

1.11 Further details of this research, including methods, responses and our findings are provided at Annex C. The key findings of the studies are also referred to at relevant points throughout this report.

Public consultation

1.12 We decided to seek the views of stakeholders on those local government finance issues that were within the remit of the Review. The invitation letter posed a number of questions based on the Review's work so far.

1.13 Of the responses, about two thirds (135) came from local authorities. The rest came from members of the public or other organisations.

1.14 The main points were as follows:

- the three issues identified as most serious were (i) high council tax levels, (ii) gearing and its impact on accountability, and (iii) central government control over local spending (e.g. ring-fencing);
- the current system was widely seen as unaccountable owing to complexity, lack of clear responsibility for services and central government control;
- most local authorities blamed gearing (and the balance of funding) in part for public confusion and low local election turnout, though other responses did not consider it significant;
- council tax in its current form and at current levels was becoming unaffordable for those on fixed incomes;
- it was not buoyant enough;
- an equalisation system was needed, but there were concerns with the current grant distribution system;
- the principles that people felt most strongly about were 'fairness' (i.e. ability to pay) and accountability. Equalisation, buoyancy, predictability, and collectability were also seen as important;
- most local authorities wanted business rates to be re-localised, but business organisations were strongly opposed;

- some respondents wanted council tax to be kept but reformed. Some wanted it replaced by a local income tax (LIT). Some wanted both taxes;
- there was considerable interest in giving local government a wider range of revenue sources, including smaller taxes and charges.

1.15 Annex D provides greater detail on the consultation process and the responses.

Wales

1.16 The legislative basis for funding local government in Wales is the same as for England. In addition, by virtue of the Barnett formula arrangements, funding for the Welsh Assembly Government is inextricably linked to the resources the Office of the Deputy Prime Minister (ODPM) has for local government in England. The Welsh Assembly Government has therefore undertaken a consultation on *The Balance of Local Authority Funding in Wales*.[1] The aim of the consultation was to consider the issues in a Welsh context and to submit the findings to this Review.

1.17 In the main, respondents to the consultation identified similar concerns to those expressed in England. In considering its response, the Welsh Assembly Government has said that it is of the view there should be immediate reform of the Council Tax Benefit (CTB) system. In addition, the Assembly Government would like to see further work and research on the viability of a phased return of business rates to local authority control within the parameters of suitable safeguards for the business community. It considers there is merit in further consideration of the feasibility of a LIT as a supplementary local tax, but this consideration should be alongside that given to other potential forms of local charges and taxes.

1.18 A copy of the Welsh Assembly Government's report will shortly be available on the National Assembly for Wales website.[2]

How far does the balance of funding matter?

1.19 As the beginning of this chapter records, the Government agreed to set up the Review in response to local government concerns that the present balance of funding was a problem because it undermined local authority accountability and gave rise to the gearing problem.

1.20 'Gearing' is simply the term used to express the fact that a given percentage increase in local authority spending budgets will require a larger percentage increase in council tax. Local authorities' dependence on Government grant means that for every 1% increase in spending they need, on average, to increase council tax by 4%, a 'gearing ratio' of 4:1. There is, however, a wide variation in gearing across individual authorities which varies from around 2:1 in authorities with the largest council tax bases to 9:1 or more in authorities with the smallest taxbases (which tend to be those with the highest needs). Because of the gearing effect, comparatively small spending pressures can lead to some big increases in council tax for individual taxpayers.

1 at http://www.wales.gov.uk/subilocalgov/content/consultation/la-funding-wales-e.pdf

2 at http://www.wales.gov.uk/subilocalgov/index.htm

Public consultation results

1.21 The local government response to the Review's public consultation confirmed the depth of concern about gearing which, for many, lay at the heart of the problem with the current balance of funding.

1.22 It was argued that gearing distorts local authorities' accountability to their taxpayers and gives the impression to the public of huge council tax rises for limited service improvements. The level of gearing reflects the authority's balance of funding; thus many responses argued that, if more funding were raised locally and gearing were reduced, accountability would improve. Poor accountability was not conducive to efficiency.

1.23 It was also argued that one reason for low turnout at local elections was that people do not feel that their vote makes a difference and do not see a clear connection between their tax and spending decisions. On that basis, many responses argued there was a direct connection between the balance of funding and turnout. However, other responses found the evidence inconclusive and suggested that there might be an indirect link, but that the reasons for low turnout were likely to be much wider, and due to a general lack of interest in the issues, not specifically to the balance of funding.

1.24 Some local authorities considered the balance of funding to be a minor issue and some felt that the present balance and associated gearing effect actually helped efficiency.

1.25 Responses from the general public revealed little interest in the balance of funding itself. However, they were certainly concerned about rates of increase in council tax (to which the balance of funding is related because of the magnifying effect of gearing). The majority view of those members of the public who responded to the consultation or wrote to the ODPM on this subject was that recent council tax rises were unfair on them, as the system took little account of their fixed incomes. Furthermore, many responses from taxpayers showed frustration and cynicism with local and central government, in part due to inability to determine where responsibility for tax rises lay.

Research

1.26 ***Accountability:*** As reported in Annex C, we commissioned research on whether or not there could be a direct connection between the balance of funding and local election turnout. We accepted Professor Rallings's conclusion that the available evidence did not demonstrate a direct connection.

1.27 The focus group research for the Review by NOP World found no evidence that the current funding system had any effect on voter behaviour.

1.28 ***Efficiency:*** There was also research to see whether more highly geared authorities were more efficient because they had a stronger incentive not to increase council tax. The in-house work by ODPM found that any association between balance of funding and efficiency was weak. Moreover, the association was negatively correlated in that those authorities which depended more on local funding performed slightly better. However, that might be due in part to their relative affluence. The research identified a strong link between high gearing and deprivation.

1.29 ***Public attitudes:*** Focus group research found that most people knew little about the balance of funding. When asked to guess, most assumed that councils raised 70-80% of their funding locally through council tax. They were surprised to learn the true position. However, they claimed that it did not matter much provided that there were effective checks and balances on the way the money was spent.

Conclusion

1.30 Gearing can cloud the accountability and transparency of local spending decisions and can contribute to unsustainable council tax increases. It is clearly a cause for concern amongst local authorities, and amongst the general public, in so far as it contributes to their concerns about council tax increases.

1.31 Changing the balance of funding in favour of more locally raised revenues would reduce gearing across the board and improve funding flexibility, allowing local authorities to vary spending levels and fund additional pressures with smaller percentage increases in council tax. However, whilst it would ease the difficulty, it could not remove it altogether.

1.32 The research commissioned by the Review does not of itself prove the case for a shift in the current balance of funding. However, there is a question of principle about whether it is right for local authorities to be so dependent on central government grant. How far can authorities be properly accountable to their taxpayers with the current balance of funding? How far can transparency in local spending decisions be achieved to allow local people to see more clearly the link between taxation and spending? Indeed, when considering the balance of funding more closely, we found that we were actually looking at a range of problems rather than a simple issue.

1.33 We concluded that there are strong arguments in favour of a shift in the balance of funding, but the case for any shift depends on the feasibility and desirability of any measures which might be used to achieve it.

1.34 The following chapters set out the four main reform options put forward during the public consultation, and discuss their pros and cons.

Could gearing be fixed through the grant system?

1.35 The Chartered Institute of Public Finance and Accountancy (CIPFA) presented a paper[3] to the Steering Group on how the gearing problem might be alleviated through the grant system without changing the balance of funding. This reached the following main conclusions:

- gearing was caused by a detailed feature of the current funding system – the fact that grant entitlements were fixed by reference to notional budgets;
- gearing effects could be relaxed or completely removed without necessarily adjusting the balance of funding;
- a system of core and top-up grants would obviate gearing;

3 BoF 14: The Balance of Funding and Gearing

- such a system would improve transparency and make the whole system intuitively more logical, without, at the local level, sacrificing any of the benefits of stability and certainty of the current system. Further work would be necessary to translate these theoretical benefits into a practical working model in which perverse incentives were minimised;
- the proposed system would potentially create a degree of uncertainty around the national grants budgets. In theory there were a variety of ways in which this risk could be mitigated. But in practice a number of the options might be counter-productive. A convention of automatically adjusting the following year's grants budget for the effect of any overall underspending or overspending might be an attractive option for both central and local government interests;
- any changes to the current system would be likely to have unintended redistributive effects. It would be important to model and quantify these carefully. It might be appropriate to make an adjustment to core grants to re-balance distribution;
- it would also be important to model the proposed changes outlined over the medium term so that their cumulative effect over a series of years could be anticipated.

Conclusion

1.36 There was concern within the Steering Group that CIPFA's proposal would amount to 'the more you spend the more you get' and would set perverse incentives. The only means central government would have to control the overall level of expenditure would be capping, which would not be welcomed. This might be addressed using the proposal in the paper that the following year's grant could be adjusted for the effect of any overall underspending or overspending. The proposal might also, however, inject an undesirable degree of volatility into local and central budgets. The main view in the Steering Group was that the proposal should not be pursued.

Chapter 2
Principles of the System

2.1 The ramifications of changes to the local government finance system are significant and wide ranging. We decided that, before addressing particular options for changing the balance of funding, we had to identify a set of key principles to consider in our discussion of these options in order to ensure that we could compare the pros and cons of each option consistently.

2.2 We therefore commissioned a joint paper on principles from two Steering Group members, Professor Gerry Stoker and Professor Elizabeth Meehan.[1] We also considered papers on accountability[2] and equalisation[3] prepared by the secretariat and took note of the responses to the public consultation (of which more details are in Annex D). This work and discussion identified a wide range of relevant principles, including:

- accountability to the local electorate and local taxpayers;
- equity in the distribution of resources between different areas;
- the fairness of the taxes that are raised;
- buoyancy, i.e. growth in revenues in line with economic growth and the need for more than one local tax to give greater flexibility;
- partnership, i.e. encouragement of joint working between different authorities;
- predictability and stability of revenues;
- the degree to which possible changes could shift the balance of funding;
- economic implications such as the impact on individual incentives and behaviours;
- consistency with Government macroeconomic policy;
- affordability;
- administrative feasibility and cost.

The Review's key principles

2.3 In the light of our discussion we identified the following principles as the key criteria against which we should assess reform options:

- the potential impact on the balance of funding: how far each option could be used to effect a significant shift in the present balance;
- local accountability: how far an option would alter local authorities' accountability to their electorate and taxpayers, and improve the transparency of local spending decisions;

1 BoF 6: Local Finance: Guiding Principles in Context

2 BoF 7: Equalisation and Gearing

3 BoF 8: Accountability in Local Government Finance

- progressivity and fairness: how far each tax option would relate to taxpayers' relative wealth or income, or to some other definition of fairness;
- evenness of distribution: how significantly the taxbase of each option would vary between different areas, and the degree to which it would require equalisation;
- buoyancy: how far the revenues from each option would rise in line with economic growth;
- predictability: how far each option would yield a predictable revenue stream in a particular financial year or from year to year;
- collectability/administrative ease: how far each option would yield a revenue that was easy to collect and cost effective.

2.4 The rest of this chapter briefly sets out some issues relating to these principles.

2.5 In addition, a number of other important principles and critieria raised in discussion would need to be considered in developing any further proposals for reform of the local government finance system. These include incentives to improve effectiveness and efficiency in local government and the implications for the Government's macroeconomic policy.

Potential impact on the balance of funding

2.6 The Review's principal remit was to consider how the balance of funding could be altered by replacing central grant with additional resources from local taxation. The options identified for consideration by the Review have varying capacities to raise revenue and it is necessary to note this when assessing them. Chapter 1 provides a more detailed discussion of the current balance of funding and debates about its importance.

Accountability

2.7 A key aspect of any finance system is the need for accountability in connecting spending decisions, tax-raising and voters' choices. However, there are options to be considered in delivering accountability.

2.8 One basic argument – and this was the majority view of the Layfield Committee in their 1976 Report[4] – is that accountability requires that those responsible for spending money should also be responsible for raising it. *Average accountability* requires that those who pay should control what is done with the money raised. Proponents of this argument contend that, if local councils rely on their services to be funded from the centre, those services will ultimately be under the control of central government.

2.9 However, there are other ways in which accountability issues can be addressed. A key alternative is *marginal accountability* which requires a focus on local discretion over marginal shifts in spending. From this perspective, central funding for services, especially if there are relatively few strings attached, does not undermine accountability as long as there is some scope for discretion in the system. Marginal accountability requires clarity over any provision of central grants or monies and freedom to vary

4 Local Government Finance – Report of the Committee of Inquiry under the Chairmanship of Frank Layfield Esq QC, HSMO 1976

spending and taxes at the margins. Marginal accountability can deliver transparency without the major change in the balance of funding demanded by average accountability.

2.10 We discussed accountability in some detail and reached the following conclusions:

- most people do not understand how the local government finance system works, thereby obscuring accountability; greater transparency in local spending decisions would allow local people to see more clearly the link between taxation and spending;
- the need for equity does not rule out improving accountability;
- local government is ultimately accountable to local people. However, the Government has the right to set a limited number of national standards for key local services;
- the balance of funding is far from being the only accountability issue. For example, the balance of control, and the quality of communication between a local authority and its electorate, have also been identified as important issues;
- improving accountability should benefit central-local relations and increase local authority efficiency.

Progressivity and fairness

2.11 A key principle of any system of finance is that the public should see the taxes or charges as fair, justifiable or legitimate. This might well include a consideration of the degree to which a tax is progressive to income or wealth (i.e. it raises a greater proportion of revenue from individuals with higher incomes or wealth). In this regard, it is also essential to consider individual taxes in the wider context of the tax and benefit system as a whole. Taxes and charges may also be intended to promote sustainability in the use of resources, to provide incentives for changes in behaviour, or simply to reflect the costs of providing a service to an individual.

Distribution and equalisation

2.12 There is a significant degree of variation between local authorities in terms of the needs of their populations, and the size of their local taxbases. It is generally accepted that the local government finance system has an important role to play in ensuring that each local authority across the country has access to an equitable level of resources.

2.13 The current system equalises fully for both needs and the size of the council tax base at the level of Formula Spending Share (FSS). The paper by the Review secretariat on equalisation issues explained that it would be possible to shift the balance of funding while maintaining current levels of equalisation. Currently central government pays a grant to all authorities – including the richest – and therefore provides more grant to local authorities as a whole than is necessary to ensure equalisation at the level of FSS. This 'headroom' could instead be raised locally without reducing the scope for equalisation. Currently, the centre distributes resource to meet about 75% of total local authority spend.

2.14 We agreed that the local government finance system, whatever it was, must ensure equity between local authorities.

Buoyancy

2.15 Council tax is not a very buoyant source of revenue, in the sense that revenues do not rise (or fall) in line with the performance of the economy, as is the case with some other taxes like income tax. Such buoyancy as it has comes from the fact that there is a slow net growth in the number of houses from year to year.

2.16 It is argued that a more buoyant local tax would give local authorities a greater degree of flexibility and allow them to benefit from the increased tax revenues delivered by economic growth. Against this some argue that the lack of buoyancy in council tax reinforces accountability and provides incentives for greater efficiency because it ensures that changes in spending levels require changes in the rate of council tax which can be clearly perceived by local taxpayers.

Predictability

2.17 In order to be able to plan their spending and manage their finances prudently, local authorities need to have some degree of certainty about the resources that will be available to them in the future. The degree to which the yield from any potential local tax can be predicted in advance, and the degree to which it can fluctuate from year to year, is therefore an important consideration when assessing its appropriateness as a source of revenue for local government. This issue would be more important if the balance of funding were shifted substantially towards local taxation, as in this case a shortfall in local revenues would have a more significant impact on a local authority's budget than is currently the case.

Collectability and administrative ease

2.18 A local tax needs to be able to be collected reliably and without local authorities (or any other body responsible for collecting the tax) incurring disproportionate administrative costs. Amongst other issues, the degree to which the taxbase is mobile or immobile and the degree to which the tax can be easily evaded are therefore important considerations in assessing options.

Conclusion

2.19 It is important to note that, although each of these principles may be more or less desirable in theory, there are often significant trade-offs that need to be made between them in reality. For example, the yield from a buoyant tax is likely to be less predictable than from a non-buoyant tax, and the more progressive a tax is, the more the distribution of the taxbase will vary between different local authorities. These and a number of other trade-offs are identified in the following chapters, which summarise the Review's work on individual reform options.

Chapter 3
Reform of Council Tax

3.1 The first option on which we decided to seek further evidence following the public consultation was reform of council tax.

Council tax at present

3.2 Council tax was introduced in 1993 as a replacement for the community charge ('poll tax'). It is a tax on domestic properties based on a system of valuation bands related to capital values. But the tax also relates to the number of adults living in the property in that there is a discount for single occupants. The two key elements of the council tax system are the bands and the ratio. There are eight bands and each property is put into one of them according to an assessment of its value in 1991. The bands are set out in the table below:

Band	Lower Limit £ (exceeding)	Upper Limit £ (not exceeding)	Council Tax as multiple of Band D
A	0	40,000	6/9
B	40,000	52,000	7/9
C	52,000	68,000	8/9
D	68,000	88,000	9/9
E	88,000	120,000	11/9
F	120,000	160,000	13/9
G	160,000	320,000	15/9
H	320,000	No limit	18/9

3.3 Council tax within a local authority area must vary between bands in a set ratio. The charge on a Band A property is two-thirds of the charge on a Band D property and the charge on a Band H property is twice the charge on a Band D property. So those in the most valuable properties will pay three times the tax of those in the least valuable properties, other things being equal.

3.4 The full rate of council tax is paid on dwellings occupied by two or more adults. Properties occupied by only one adult get a 25% discount. Until the current financial year, there were discounts of 50% for second homes and long-term empty properties, but the Local Government Act 2003 now allows local authorities to reduce these to 10% for second homes and 0% for long-term empty properties. Some categories of people are exempt from council tax liability, for example students and those suffering from severe mental incapacity. Council Tax Benefit (CTB) exists to help those on low incomes with their council tax bills.

3.5 Council tax is the only tax available to local authorities, but they are free to increase or decrease the rate. The average Band D council tax in England is £1,167 in 2004/05, but this varies sharply between areas from £601 at one extreme to £1,376 at the other. The average bill paid per dwelling, at £967, is lower than the average Band D council tax. The Government retains reserve capping powers to prevent local authorities levying excessive council tax increases.

3.6 District councils are responsible for collecting the council tax in areas with both a district and a county council. Other authorities, such as the county council or the police authority, raise a 'precept' to meet their financial needs. The amounts of tax due in respect of these precepting authorities are identified separately on the bill.

3.7 The Government is committed to revaluing properties for council tax purposes based on 2005 property values. The new values will then be used as the basis for bills from 1 April 2007 onwards. The policy is that the total yield from the council tax will not increase as a result of the revaluation. Other things being equal, revaluation will mean that the tax burden will be decreased in areas with lower than average increases in house prices since 1991 and increased in areas with above average increases.

The views of consultees

3.8 Responses to the Review's public consultation showed little support for retaining council tax in its current form as the only major local revenue source. There was a range of views on whether it should be reformed or abolished, and what revenue sources should supplement or replace it. However, many respondents in all groups favoured reform. For example, one response argued that, despite recent rises, council tax was "a fundamentally sound basis on which to raise a proportion of local authority funding". Many who argued that it should be kept but reformed said that it should not be the only major local tax.

The case for council tax

3.9 On its introduction council tax was widely accepted. Its benefits are that:

- it is the only tax on residential property values (and property taxes are widely used in other countries);
- it is an existing tax under the control of local government;
- the basic principles are easy to understand;
- it is easy to collect – in England in 2003-4 96.5% of council tax for that year was collected in-year; ultimate collection rates are even higher;
- the yield is easy to predict.

3.10 It was also suggested during our discussions in the Group that council tax encourages efficient use of the housing stock by discouraging people from living in houses which are larger than they need.

3.11 More recently, some concerns about council tax have been voiced, for example that it is:

- 'regressive' i.e. although those in higher band properties pay more, those in lower band properties spend a higher proportion of their income on council tax than those in higher bands. It therefore bears more heavily on those on low incomes especially if they live in higher band properties. The structure of council tax means that it is also regressive to property value – while the ratio between property values in the top and bottom bands is at least eight to one, the ratio between the amounts of tax payable is only three to one;

- not 'buoyant' i.e. revenue does not rise as the economy grows.

3.12 As mentioned above, CTB exists to tackle the difficulties faced by those on low incomes. However, low levels of take-up reduce its impact, and mean that, at current levels, the overall effect of council tax is still regressive to income. Full take-up would reduce regressivity significantly, but not remove it. Take-up is particularly low amongst pensioners who are owner-occupiers.

The scope for council tax reform

3.13 The New Policy Institute (NPI) was invited to present evidence to us on the scope for council tax reform because they had already done considerable work on the issue for Help The Aged, the Special Interest Group of Municipal Authorities (SIGOMA), the Association of London Government, trade unions (the Public and Commercial Services Union and Unison), and the Local Government Information Unit. They presented papers to us in January[1] and May.[2] The rest of this chapter draws fully on NPI's analysis. (It should be noted that the forecasts presented by NPI are only illustrative in that they represent the effects of a revaluation at 2002 house prices, applied to the 2003/04 financial year.)

3.14 NPI's paper highlighted three main questions in respect of council tax reform:

- would 'basic' revaluation – that is, simply rolling the current system forward to take account of house price inflation – result in a satisfactory outcome or is some degree of reform needed?
- if the tax is to be reformed, should it be a moderate reform (with the big changes restricted to the top and the bottom of the property ladder) or a much more radical one (for example, with multipliers proportional to property values)?
- if the tax is to be reformed should it continue to be a system that is uniform across the whole of England, or should it contain some sub-national (e.g. regional) variation?

3.15 Each of these issues is addressed below.

3.16 The NPI emphasised that it is important to recognise that even small, seemingly technical, changes could have major nationwide implications. Three interlocking elements of the council tax system are the cause of this:

- that equal property value means equal band;
- that equal band means equal tax (subject to local decisions about setting a different spending level from Formula Spending Share (FSS));
- that for each local authority, central government grant makes up the difference between the authority's share of Assumed National Council Tax and its FSS.

1 BoF 16: Options for Reform of Council Tax

2 BoF 24: Reform of Council Tax: Further Thoughts on Selected Issues

Would 'basic' revaluation be satisfactory?

3.17 NPI presented an assessment of 'basic' revaluation which strongly suggested that it would be unsatisfactory.

3.18 Because house price inflation since 1991 has been higher across the South than the North and the Midlands, there is huge variation between different parts of the country in the distribution of homes across the different bands. NPI's analysis showed that in the North West 75% of homes after 'basic' revaluation would be in Bands A or B, compared with just under 40% in the South West and just 6% in London. By contrast, the present position is that the proportion of homes within Band A or B is 63% in the North West, 42% in the South West and 17% in London. The substantial difference between the North West and London – much greater than at present – might call into question the extent to which the council tax system was really a truly national system.

3.19 The way that the council tax system works means that the shift in the distribution of homes across bands would leave southern councils able to raise a greater share of their money locally, so requiring less central government grant as a result. For most northern and midland councils, the opposite would be the case.

3.20 The detailed picture of winners and losers by region presented by NPI illustrated the difficulties:

- in particular, although bills in northern regions would fall on average, they would not fall for homes already in Band A. By contrast, average bills for those now in higher bands in the North would go down; for example, homes in the North West now in Band F would see a fall in bills of 10% on average. So, while the North on average would 'gain', the gainers would be restricted to homes now in Band B and above (a minority of homes, given that more than half are in Band A);
- in London, the pattern would be very much the reverse. For example, bills on average would rise by 15% for homes now in Band C. This reflects the fact that most homes now in Band C in London would go up one band – and in a few cases two. But homes now in Band H – the top band – could not go up a band. So, whereas average London bills would rise, bills for those in the highest value homes would not.

3.21 NPI's analysis strongly suggested that 'basic' revaluation would be difficult to defend and that some reform of council tax would be required at the same time.

What sort of council tax reform?

Number and structure of bands

3.22 NPI pointed out that the heart of the current banding system, Bands B to F, follows a regular pattern in which the upper limit of each band is about 30% above the lower limit for that band. Short of moving to a very different-looking system (for example, one with many, smaller bands), they argued that there seems to be no reason to do anything to these bands other than to bring them up to date. On this basis, band re-structuring might therefore need to focus on Bands A, G and H where the pattern does not apply.

3.23 NPI suggested that Band A could be split into two bands as advocated by many proponents of council tax reform. One reason for splitting it would be its size; Band A currently has the greatest number of homes in it nationally and dominates in the five northern and midland regions. Band A nationally has 26% of homes. But in these five regions the range is from 33% to 59%. A second reason would be that it spans, in proportional terms, a very large range of property values from under £10,000 all the way up to £40,000, which is far larger than any except Band H. A third reason is that splitting it would be a way of ensuring that at least some people in Band A in low inflation areas would see a reduction in their bills after revaluation.

3.24 NPI suggested that Band G might also be split. Stretching from £160,000 to £320,000, it is effectively a double band. One effect of this is that Band G properties could increase in value as a result of revaluation by a greater percentage than properties in Bands A to F before they moved up a band, and received a higher council tax bill. NPI argued that splitting Band G about 40% of the way up would create two bands of equal proportional size which would more or less continue the regular progression already present across Bands B to F.

3.25 Splitting Bands A and G into two would create a 10-band system and that was the basis for NPI's illustrative analysis. However, they also suggested that Band H which currently covers all properties valued at over £320,000 could be split into two, three or even more bands to reflect the pattern already present in Bands B to F. NPI advised that getting the successor to Band H right was a key part of any reform; up to date information on property values above Band G was vital.

Multipliers

3.26 The progressivity of council tax could also in theory be improved by changes to the multipliers which determine the ratio between the amounts payable in each band. NPI noted that there is no limit to the number of precise possibilities for the multipliers, but the matter basically boils down to a choice between:

- moderate reform, in which the multipliers are the same as the current set, except at the ends, that is, Bands A, G and H; or
- radical reform in which the whole set of multipliers is tilted so as to increase the extent to which council tax rises as property value rises.

Moderate reform of multipliers

3.27 NPI's analysis illustrated a moderate reform where the current multipliers for Bands A2 (the upper part of a split Band A) to F would remain unchanged. A new, lower part of Band A (A1) might be given a slightly reduced multiplier of 5/9 while both parts of the now split Bands G and H might receive multipliers that represented an increase of between 30% and 40% on what they pay now.

3.28 They argued that many of the problems identified with basic revaluation would be avoided in this scenario. In particular:

- because of the rise in taxbase, there would be small reductions for all those homes below Band G that stayed in their current band;
- there would be larger average falls in tax for Band A properties because some would now get a lower bill, given that the multiplier for Band A1 was lower;

- because of the changes in the multipliers for Bands G and H, more expensive properties in high value areas would face larger rises than their more modest neighbours.

3.29 NPI explained that the multipliers envisaged in this scenario could be justified in terms of the ratio of average household income in each band to the amount of council tax paid. For each of Bands B to F, average income rises in the same proportion as the council tax multiplier currently rises. This suggests that the focus of reform of the multipliers should be on properties at the top and bottom, rather than in the middle.

3.30 The one problem from basic revaluation that would remain unaltered in this scenario is illustrated by the fact that Band C properties in London, for example, would continue to face substantial, double-digit percentage rises, well above anything faced by comparable properties (or comparable households with comparable incomes) elsewhere in the country.

Radical reform of multipliers

3.31 NPI also illustrated a more radical scenario where the multipliers would rise much more steeply in line with property values to ensure that higher value properties were taxed much more heavily than cheaper ones, in a way that was more proportionate to their value than the present system. At the moment the ratio between the tax paid between Bands H and A is just three to one, compared with a ratio of underlying property prices that could easily be twenty to one. NPI's alternative scenario showed that, if the multipliers were to stretch from 2/9 for Band A1 to 48/9 for Band H:

- average bills for homes now in Band A would fall sharply, by around 40% across the North West, and by around 30% across the South West. By contrast, homes currently in Band F in those regions would rise by 6% and 30% respectively while bills for Band H homes in London would rise by 175%;
- the relationship between the new system and the old would be clear, namely that, in future, homes in bands below D would pay less and homes in bands above D would pay more.

3.32 Apart from that overall pattern of winners and losers there would be a number of practical issues to consider:

- the scenario would entail a shift in the balance of central government grant from the South to the North and Midlands of something around £1.8 billion a year – which would be likely to be very controversial;
- as with previous scenarios, Band C homes in London would continue to face big double-digit percentage rises – 18% in this particular scenario;
- average changes could mask very large changes, both up and down, in the bills faced by individual households;
- the step changes from band to band would be larger.

Council tax reform with sub-national variation?

'Horizontal' or 'inter-regional' equity

3.33 The main problem with reform of council tax within a national framework is the possibility of double-digit percentage increases in tax faced by people in cheaper properties in high inflation areas, such as those now living in Band C properties in inner London.

3.34 This would mean that, after revaluation, London homes in any particular band would be paying a greater share of their income in council tax than homes in that band across the country as a whole. This is not generally the case at the moment. Instead, the ratio of council tax to income in any given band and in any particular region is usually very close to the national average for that band. The exception is the South West where there are many retired people on low incomes living in higher value properties.

3.35 In the interests of equity, NPI argued that it would be desirable that the council tax system should continue to exhibit this inter-regional equality after any revaluation – in other words, that the ratio of council tax to income for homes in any particular band should be the same across different parts of the country. NPI called this 'horizontal equity'. The NPI's analysis shows the following:

- at present, the ratio of council tax to income in the South West is about 10% higher than the national average across almost all bands;
- any form of national, eight-band revaluation would reduce the degree of horizontal equity in the system. London would join the South West as an area where the ratio of council tax to income is about 10% above the national average. By contrast, the North West, Yorkshire and Humberside and the eastern region would see ratios below the average.

Sub-national reform or special measures

3.36 To illustrate a possible way to address this problem, NPI provided a scenario that used the multipliers proportional to income discussed above within a 10-band, regional council tax system. This assumed that properties would be revalued on a regional basis in line with property value increases in each region rather than the national average increase. The uplift for each region's band limits – uniform across all bands for a region – was in line with average house price inflation since 1991 for the region. The one exception to this was that bands in the South West were increased by an extra amount in order to try to eliminate some of the horizontal inequity in the current system for the South West.

3.37 The main features of this illustration were as follows:

- although more homes would go down a band (3 million) than up (2.5 million), the taxbase would rise owing to the increases in multipliers in the higher bands. Many homes staying in the same band would therefore see a slight fall in their bills;
- there would be very little change in the current pattern of grant support, with Government grant of just £80 million flowing to the northern and midland regions;
- the proportion of homes below Band C in the North West would fall to 60% – slightly below the current level. 15% of homes in London would remain below Band C, also slightly down on now but much higher than the 6% under a purely national approach;
- Band A homes would enjoy, on average, larger falls in their bills (6%). On average, Band C homes in inner London would still face a rise, but it would now be a more modest 4% rather than the substantial double-digit percentage increases that would arise under a national reform.

3.38 Because of the changes in multipliers assumed in this illustration, the overall degree of progressivity in the system would be higher than now. This would have the advantage of dealing with the problem of the big rises faced by cheaper homes in high inflation areas. However, as NPI pointed out, there are many potential variants to it. So, even if some form of sub-national banding were to be pursued, many questions would remain to be answered, for example:

- whether to stick with the idea of a single Band A but reduce the multiplier. Splitting Band A would make a great deal of sense in a national system, but would be nowhere near as important in a system with sub-national variation;
- whether, with sub-national bands, higher multipliers than those used in NPI's illustration could be justified for the top bands to achieve further progressivity given the caveats at paragraph 3.41;
- whether the established Government Office regions are the best basis for sub-national variation or whether some other geographical boundaries would be more satisfactory.

3.39 There was concern within the Steering Group that a regional approach would create 'cliff edge' problems i.e. very different tax rates for houses of similar value in adjacent areas. NPI's provisional conclusion in response to that concern was that cliff edges arising from regional bands would not be a major problem. However, there was also concern within the Group that 'hotspots' within larger areas were also a problem and could lead to a situation where, for example, home-owners could find themselves paying a higher council tax than a home-owner with an equivalent property nearby in the same region because of differential price movements.

3.40 Concerns were expressed about the possible 'blanket effect' of regional banding, and sub-regional banding was suggested as an option, for example splitting inner and outer London. However, to go below regional level would be to increase the tension between complexity and comprehensibility in the system.

Caveats

3.41 NPI also drew attention to the following caveats:

- it is not necessarily as easy as one might think to make the system fairer in reality. Neither gross nor net income necessarily reflects 'ability to pay' all that well. For example, households containing children have to spend more on food and clothes, and the cost of living varies between different parts of the country;
- while, on average, higher income households tend to live in more expensive homes, the relationship only applies in the aggregate; people with similar incomes can and do live in very different-sized and priced homes; and people in similar-priced homes can and do have very different levels of income. There is the particular issue of pensioners on low incomes who live in high value properties. Similarly, people renting high value properties may also be on low incomes yet face high council tax bills. Unless take-up of CTB is improved, making council tax more progressive would disadvantage some people in these groups.

Council Tax Benefit

3.42 Finally, NPI flagged that the effectiveness of the CTB system was vital to the success of any reform of council tax because it offered a potential solution to the sensitive problem of the person with a low income living in a large house. NPI's key points were as follows:

- one practical problem with the current system was that the savings limits within CTB meant that it took only around £10,000 of additional saving to eliminate all entitlement to a benefit worth typically £1,000 a year. They argued that this was disproportionate and that the case for relaxing the impact of savings on entitlement, if not abolishing it altogether, merited consideration. (It was noted that the savings limits had not changed since they were introduced nearly 15 years ago);
- a second practical problem was that CTB had very low take-up – around three-quarters overall, around two-thirds for pensioners and less than half for pensioners who are owner-occupiers. This level of take-up was lower than that for any other benefit.

3.43 While NPI welcomed campaigns to raise take-up, these did not get to the root of the problem. To do that, NPI argued that the appearance and administration of the CTB system should be altered, so that instead of applying for a benefit households should apply for a cap on their liability to council tax based on their income. While arithmetically this was just the same as CTB, it would both be easier for the citizen to understand and avoid the indignity that was often felt – not least by older people – when applying for 'relief' from the state. It also opened the way to a process whereby CTB was processed in the same way as pension/tax credits rather than requiring a separate application specifically for CTB. NPI's judgement was that this could have a major impact on take-up rates.

3.44 We noted that the Department of Work and Pensions have in hand a number of measures to improve take-up, including a take-up campaign. In particular, from 1 April 2004 they have abolished the restriction which used to limit the maximum CTB for people in council tax Bands F, G and H. They are considering NPI's proposals.

Assessment of pros and cons against Review principles

3.45 As mentioned in Chapter 2, we identified a number of criteria against which reform options should be assessed. NPI's assessment was as follows.

3.46 ***Impact on balance of funding:*** NPI concluded that:

- unless council tax were subject to a very radical reform indeed, the council tax would never be capable of sustaining a continuing shift from central funding to local funding. Such shifts would always be regressive, to the disadvantage of lower income households;

- by contrast, there might be scope for a one-off shift in the balance of funding that accompanied a radical reform of council tax. But there would still be many losers on below average incomes.

3.47 NPI concluded that, whether council tax reform, even quite radical reform, would really help with the balance of funding remained an open question.

3.48 ***Local accountability:*** A reformed council tax would be neutral in terms of local accountability. However, NPI flagged that there might be some loss of accountability during any transition if households were unable to distinguish how far any rise in council tax was due to the reform itself, and how far to additional spending undertaken by the local authority. They therefore saw local accountability as being closely tied to transparency of reform and whether a clear story could be told about how the reform had affected any individual household's bills.

3.49 ***Progessivity:*** NPI's work clearly shows that in principle council tax could be made more progressive to property value by reform that would change the bands and the ratios between them. The degree of progressivity would depend on the precise scheme chosen. Better take-up of CTB is also important. Unless this is resolved, making council tax more progressive would hurt some of those on low incomes living in high value properties.

3.50 ***Evenness of distribution:*** Any reform of council tax would lead to changes in the distribution of houses across the different council tax bands in different parts of the country. Such changes would affect local taxbases and thus the distribution of central government grant between local authorities. As a result, the variation in gearing ratios would increase. Poorer authorities would face even steeper gearing ratios while more prosperous authorities would see their gearing ratios fall.

3.51 ***Buoyancy:*** In theory, it would also be possible to make council tax more buoyant. This would require the taxbase to be tied more closely to house price movements – assuming that they would increase year on year. That would require regular (e.g. annual) updating of the taxbase which is technically not possible at the moment but might be possible in the medium term. However, in practice the costs and upheaval associated with more regular revaluations would also have to be considered.

3.52 ***Predictability and collectability:*** None of the options for reform of the council tax would have much impact on predictability or collectability. Administrative ease is, however, very relevant for CTB reform.

Conclusion

3.53 Our main conclusions on reform of council tax are as follows:

- council tax has important advantages. There is a strong economic case for a tax based on property; council tax should be retained but reformed;
- there is not always a strong link between people's income and the value of their property and council tax is therefore, especially in its current form (given poor take-up of CTB), regressive to income;

- there is a clear case for reviewing council tax bands and the ratios between them at the time of revaluation. However, particular care is needed to ensure that council taxpayers on low incomes living in high value properties are not unfairly affected;
- the detailed case for and against some kind of sub-national approach should be considered. Again, further work is needed to determine the best solution, taking account of possible 'cliff edge' problems. The case for a sub-national approach may be weaker if the national divergence in property prices continues to close;
- a fair and effective system of CTB is essential to the continued acceptability of council tax. Take-up needs to be improved and NPI's proposals for changing the savings limit and transforming CTB from a means tested benefit into a maximum liability scheme should be examined seriously. Improvements to CTB and measures to improve take-up need not and should not wait for structural reform of council tax;
- it would be difficult to change the present balance of funding by raising a significantly higher proportion of local funding through council tax even if it were reformed.

3.54 In short, much further detailed work is required on how council tax might be reformed, based on a clear vision of the direction of travel. It must now be for the Government to decide that direction of travel.

Chapter 4
Reform of Business Rates

4.1 The second option which we decided to consider further was the reform of national non-domestic rates (NNDR, also known as business rates).

4.2 Business rates are a tax on non-domestic property. They are collected by local authorities, who until 1990/91 also had the power to vary the rates and keep the proceeds. Since then, they have been 'national' – paid into a central pool and redistributed to authorities on a per capita basis. Annual increases in the rate are limited by statute to inflation.

The views of consultees

4.3 Almost all consultation responses from local authorities suggested that business rates should be re-localised (in addition to reforming council tax and/or localising other taxes). They argued that this alone would in one stroke resolve the balance of funding issue by increasing the proportion of revenue raised locally to about 48%.

4.4 Supporters of re-localisation also argued that it would be beneficial in itself to both local authorities and business. They argued that it would improve partnership working between the two as business would have a stake in engaging with local authorities. Although the Government had announced new schemes to encourage such joint working, the Local Authority Business Growth Incentive[1] and Business Improvement District[2] schemes, it was suggested that these could have a marginal impact only.

4.5 By contrast, almost all consultation responses received from business (and a few local authorities) were opposed to any change in the current system, which they thought worked well. They said local authorities would raise business rates to fund services for voters or take pressure off council tax, at the expense of non-voting business taxpayers. This would worsen relations between business and councils. Not only did businesses expect to be charged more under localised business rates, they also feared that rises would be arbitrary and sudden, and that, because rates would vary by area, there would be an uneven playing field for business. This could damage UK international competitiveness and lead to significant compliance costs. Some councils acknowledged there were serious business concerns and proposed some safeguards to meet these concerns.

4.6 Another issue raised was the current cap on annual rises in business rates. Some responses argued that this cap should be re-examined in light of the increasing burden on the domestic local taxpayer – in other words that business rates should be allowed to rise faster to reduce council tax increases.

1 The Local Authority Business Growth Incentives (LABGI) scheme will encourage authorities to work with business by allowing them to keep part of their business rate revenue if this exceeds a pre-set floor. It will apply to all authorities, none will lose out, and no business will pay more. It will start in April 2005.

2 Business Improvement Districts (BIDs) will allow businesses in an area, in partnership with the local authority and subject to a business vote (a numerical majority and one weighted by size are needed), to raise their rates to pay for specific improvements to business services.

4.7 Some responses acknowledged that the amount of business rates that local authorities could raise differs hugely – for example, Westminster Council alone raises 6% of the total, more than Liverpool, Manchester, Newcastle and Birmingham combined. Careful thought would need to be given to how to equalise resources under a localised business rate system. Areas or regions that now put more into the central pool than they get out (e.g. London) might argue that all their business rate revenues should be retained locally to meet local needs (and local business concerns).

4.8 Concern was also raised about the equity and fairness of local business taxes based solely on property values. These were seen to fall disproportionately on particular sectors, irrespective of their resources and ability to pay. Establishing a clearer link between business resources and the local taxation levied could make funding more buoyant and progressive.

The case for and against reform

4.9 In the light of the clear divergence of views which was indicated by the consultation responses, we invited the Local Government Association (LGA) to present the case for re-localisation and the Confederation of British Industry (CBI) to put the case against.

The case for re-localisation

4.10 The LGA's case for re-localisation was outlined in detail in their presentation to us.[3] The main points they made, as fleshed out by arguments put forward within the Steering Group, were as follows:

- as a result of the inflation cap on annual increases, the share of local government funding met by business had gone down. In 1990/91 business rates accounted for 29% of council expenditure. By 2003/04 this had fallen to 22%. In the 2004/05 RSG settlement it was 20.4%;
- re-localisation would encourage more effective partnerships between councils and business than the present system. Business had engaged seriously with councils before 1991, but since then had had no incentive to get involved as councils no longer controlled tax levels. The LGA welcomed the LABGI and BIDs schemes, but thought that their effect on encouraging partnerships would be marginal. The LGA recognised the problems encountered under the previous system, but believed that local authorities now gave a higher priority to partnerships than in the 1980s, and might be able to build better links with business under a localised system this time around;
- re-localisation would improve the balance of funding (to about 50%), which would reduce gearing and increase accountability.

4.11 The LGA pointed to evidence that there was a trade-off between rents and other property costs including rates. However, they acknowledged that, if business rates were re-localised, there would have to be safeguards for business to prevent councils arbitrarily raising the rates. These could, for example, include linking growth in business rates and council tax, so that they increased at a similar rate, or measures such as consultation with business, exemptions and reliefs for certain businesses,

3 BoF 17: Re-localisation of Non-Domestic Rates

and transitional arrangements. The LGA also pointed out that businesses would not necessarily be charged more under localised business rates. Local authorities could have the discretion to lower the rates in certain areas, to encourage regeneration. Furthermore, it was acknowledged that some equalisation would be needed, because the amounts of business rates that individual local authorities could raise differed hugely.

4.12 The LGA argued that re-localisation of business rates should form part of a wider package of reforms, as it would not resolve all the financial issues faced by local government on its own.

The case against re-localisation

4.13 The CBI case against re-localisation was outlined in detail in their presentation to us.[4] The main points that they made, as fleshed out by arguments put forward within the Steering Group, were as follows:

- business's view was clear that locally set business rates had not worked when they were last in place. Business had put significant effort into consultation with authorities over setting rate levels, but their input – while time-consuming and costly – had had little impact. This had damaged the relationship between them and it was unlikely that re-localisation in the future would improve this situation. Furthermore, the increasing need for international competitiveness meant that business was now leaner and had even less resource to devote to debates about rate levels with local authorities, which distracted both from tackling the real issues. Business still lacked confidence in some councils owing to their performance on key business issues (e.g. transport, planning) and it was important to focus on building better relationships;
- the current system protected business against unaffordable rate increases and eased forward planning. A local business rate could lead to councils simply increasing business rates, as had happened before 1991, in order to reduce pressure on council tax bills. There would also be arbitrary and unpredictable local variations in bills that would mean an end to a single national rate and again would be likely to harm relationships between business and local government;
- re-localised business rates did not meet several of the Review principles (see below). Although they would be easy to collect, the CBI saw them as unpredictable and unevenly distributed. If different areas had different business rates, it would be very complex for multi-location businesses;
- the CBI believed that localising rates was a crude way to try to solve intricate and locally varied problems and, since equalisation would still be required, it did not fulfil many of the claims of its supporters.

4.14 While the CBI acknowledged that the proportion of local funding met through business rates had fallen, they emphasised that business also contributed to local government through national taxation which was then distributed to authorities as central grant. It was critical to look at the totality of their tax burden and the need to remain competitive internationally, not just at the local tax burden.

4.15 Business had significant concerns about the risks to their productivity and competitiveness, and therefore recommended that the assessment of proposals for business rates reform be assessed against the criteria of the impact on economic competitiveness, business costs, and the full picture of the national tax burden on business.

Intermediate options

4.16 Both the LGA and the CBI acknowledged that in theory a number of intermediate options existed. Possible reforms could include:

- ***removing the inflation cap:*** As mentioned earlier, consultation responses raised this as a possibility. It was argued that, as businesses use local government services, they should pay their fair share, and should not benefit from a statutory cap on their rates while council tax payers do not. The CBI emphasised that business was against this option and highlighted the potential impact in today's globally competitive environment. Property taxes were, they argued, already higher than those in competitor countries;
- ***the LABGI option:*** This would involve retaining the national system, but allowing an element of local retention of rates, building on the LABGI scheme and the existing powers for BIDs. The LGA welcomed this proposition, although they preferred wholesale re-localisation. The CBI supported an extension as it had the potential to encourage economic growth and greater locally retained revenue. They also supported BIDs which required genuine partnership between business and local authorities;
- ***other options:*** Local authorities could set a supplementary rate on top of the national business rate, or the national rate could be retained only for the largest businesses, the rest being subject to local rates. Alternatively, business rates could be divided evenly between 'national' and 'local' elements, with a 50:50 split between proceeds retained by local authorities and those paid into the national pool. The national element could remain tied to inflation, with councils having discretion to vary the local element.

Assessment of pros and cons against Review principles

4.17 Both the LGA and the CBI assessed business rate re-localisation against these principles, as follows.

4.18 ***Impact on balance of funding:*** Re-localisation would achieve a major shift, raising the proportion raised locally from about 24% to 48%. This would reduce but not eliminate the gearing problem.

4.19 ***Local accountability:*** The LGA argued that, if giving councils greater financial powers increased people's perceptions about the importance of local government and local elections, re-localisation could improve accountability. It could also be argued that it would indirectly improve local councils' accountability to local businesses by encouraging partnerships, and that as part of local communities it was right that businesses should directly fund local services. However, business argued that the ability of councils to set local business rates would not make them more accountable. Business would have no real say in setting the rate level, nor would local authorities be accountable to them through the ballot box. Moreover, localisation could diminish accountability to voters by obscuring the link between a council's spending decisions and the level of local domestic taxation.

4.20 ***Progressivity:*** The LGA argued that, although taxing rateable value was not as progressive as other measures, for example relating liability to profits, it served to reduce complexity, while reliefs and exemptions, for example for small businesses, could be used to make the system more progressive. However, the CBI said that a local business rate would introduce arbitrary variations across the country. Businesses occupying premises of the same worth in two different parts of the country could pay very different levels of tax on each.

4.21 ***Evenness of distribution:*** As explained above, some areas would receive far greater revenues from business rates than others. This would require significant equalisation, especially at the top end of the spectrum. Without such equalisation, the CBI pointed out that those authorities with the lowest taxbases might need a relatively high local rate which would deter firms from locating and investing in those very areas most needing growth.

4.22 ***Buoyancy:*** This would depend in part on the approach taken to revaluation of business property. Business rates are not a very buoyant tax, but for local government any additional local tax would improve buoyancy and flexibility in raising revenue. Business pointed out that, with a locally set rate, there would be no automatic link between wider economic growth and increased tax take.

4.23 ***Predictability:*** Re-localised business rates would be unpredictable for businesses, especially multi-site ones, unless there were very strong safeguards. The CBI was concerned that, even if increases were linked to increases in council tax, there could be significant volatility. However, it could be argued that the price of the current predictability for businesses was greater unpredictability for council tax payers.

4.24 ***Collectability:*** Collection rates were high for the current system, and would remain so for a local business rate. However, differing rates would impose more costs and complexities on business.

Conclusion

4.25 We accept that there are strongly held views on the issue of reform of business rates. Based on the evidence presented, we identified three possible options for change, which would have differing potential impacts on the balance of funding:

- re-localise non-domestic rates, with safeguards for business, e.g. linking maximum increases to council tax increases;
- retain the national system, but lift the current inflation cap on rates increases;
- retain the national system, but allow an element of local retention of rates, building on the LABGI scheme and the existing powers for BIDs.

Chapter 5
A Local Income Tax

5.1 The third option that we decided to consider further was the introduction of a form of local income tax (LIT). A LIT plays a role in the funding of local government in many other countries (generally as an addition to a property tax rather than as an alternative). It was also an option raised by a number of those who responded to the public consultation. However, one of the issues highlighted in earlier work in this field has been the technical challenges that would be involved in implementing a LIT in the UK.

5.2 The Review commissioned the Chartered Institute of Public Finance and Accountancy (CIPFA) to look at whether a LIT was a feasible option, how it might be implemented, and what the implications for the local government finance system might be. They prepared two papers for us. The first[1] exemplified the various options and the second[2] suggested a 'possible model' of a practicable solution if the LIT were to supplement other local revenue-raising instruments.

The views of consultees

5.3 The Review's public consultation indicated significant support for some form of LIT from many of those who responded. Overall, responses were divided between the merits of a reformed council tax and LIT as the main local revenue source. Some favoured having both, while others pointed out that more debate and research would be required before any decision could be taken. The advantages of LIT compared to council tax were generally felt by proponents to be that it would be more progressive and buoyant. However, it was not clear to all those who responded on this issue how a LIT could best be collected. Some respondents suggested that it might be easier to evade than council tax.

5.4 It was not clear in some cases whether responses asking in general terms for council tax to be replaced by income tax referred to a locally set or an assigned income tax (see below). A number of responses did say, however, that both these forms of LIT should be considered as options, while others argued against a locally set income tax but suggested that a locally assigned one should be considered.

5.5 Local authority responses themselves showed a range of views – some preferring council tax, some LIT and some wanting to look at all options.

The main forms of a possible LIT

5.6 It is clear from the responses to the consultation, and from CIPFA's analysis, that the term 'LIT' covers a number of different possible forms, each with its own implications for local authorities and individuals. There were two main areas in which commentators

1 BoF 19: Reviewing the Case for a Local Income Tax

2 BoF 25: Reviewing the Case for a Local Income Tax – Supplementary Report

and respondents indicated significant divergences of opinion – whether it should be *variable or assigned*, and whether it should *supplement or replace* council tax. These alternative models are explained below.

Assigned and variable LIT

5.7 An *assigned* LIT would involve the assignment to local authorities of a set proportion of national income tax receipts. Local authorities would not have power to vary the rate of tax and hence would have no direct control over the amount they were allocated.

5.8 A *variable* LIT would give local authorities some degree of control over the rate at which the income of their residents was taxed (perhaps within centrally determined limits) and would allow them to benefit from the revenue according to the rate they had set.

5.9 In both cases it is assumed, for the purposes of the exposition, that there would be a commensurate reduction in central government grant support to local authorities, and in the rate of national income tax.

5.10 Some groups argued that an assigned LIT might be introduced as a stepping stone to the introduction of a variable LIT at a later stage.

Supplementary and replacement LIT

5.11 At present council tax forms the only locally controlled tax for English local authorities. One option for a LIT would be for it to entirely *replace* council tax as the local revenue-raising tool. However, as noted in Chapter 3, council tax has important advantages and there is a strong case for retaining it, subject to detailed consideration of options for reforming it.

5.12 Alternatively, a LIT could in theory provide a second tax tool for local authorities, running alongside council tax. The introduction of a *supplementary* LIT could be used to shift the balance of funding, alongside a reduction in central government grant and a commensurate cut in national taxation. However, there are a number of difficult issues associated even with this option which are discussed below.

Administrative issues surrounding the case for a LIT

5.13 CIPFA's papers provided a detailed analysis of the feasibility and technical issues concerned with a LIT. In doing so, they concentrated on a variable LIT, both because an assigned tax would arguably not be a 'local' tax, and because it is in seeking to give local authorities the powers to vary tax rates that the key technical challenges present themselves.

5.14 CIPFA's initial analysis clearly confirmed our understanding that consideration of the case for a LIT raised a wide range of fundamental and, in may cases difficult, issues. These ranged from who would collect the tax, how much it would cost to introduce and run, and what the burden on employers would be, to what forms of income might be taxed, and at what rate – as well, of course, as what the effect of the tax would be for individual taxpayers.

5.15 Taking into account these issues, CIPFA presented one 'possible model' of a relatively simple form of LIT, which would:

- supplement, not replace, council tax;
- be restricted to larger, multi-purpose authorities;
- restrict authorities to choosing a tax rate from a menu of, say, five predetermined rates;
- not include investment income, which would remain centrally controlled;
- see national income tax rates reduced in parallel;
- be collected via a single collection fund managed by the Inland Revenue (IR) and the Treasury;
- determine individuals' eligibility for the year according to their residence on a single date in the year.

5.16 CIPFA made clear that the design and implementation of any form of variable LIT would be a complex task. It would need a significant amount of detailed additional work to test their assumptions and models.

Administration and costs

5.17 CIPFA looked at the issue of whether local authorities or the IR should collect the tax. They concluded that local authority collection offered the possibility of better accountability, but that the IR already had the systems and experience of collecting national income tax. CIPFA's assessment was that local authority collection was not a realistic option on the grounds of administrative complexity and cost.

5.18 The IR collects income tax through a number of channels on a number of types of income from different taxpayers. The principal method is the Pay As You Earn (PAYE) system, in which employers deduct tax at source from employees' pay and remit it to the IR. Currently, higher rate taxpayers, the self-employed and individuals with more complex tax affairs also complete self-assessment returns. CIPFA's work concentrated on whether and how these systems might be modified to allow the introduction of a locally variable element. They also looked briefly at the possibility of introducing a system of universal tax returns, but concluded that this would be prohibitively complex and expensive.

5.19 The costs of administering a LIT would depend significantly on whether the LIT were to be assigned or variable (the former being clearly cheaper than the latter). Costs overall would equally depend on whether the LIT were to be a supplement to council tax or a replacement. In the former case, and leaving aside start-up costs, CIPFA estimated that a LIT administered by the IR would increase annual overall tax collection costs, perhaps by £230-370 million per year for the UK as a whole. In the latter case net savings would be possible – perhaps of the order of £140-280 million. (The costs in England only would equate to about four-fifths of these figures.) CIPFA said that, at this stage of analysis, these and other costings should be treated only as broad estimates. Costs would also depend on the precise form and coverage of the tax, including the degree of freedom which local authorities would have to set their own rates and the treatment of investment income. Moreover, these costs assumed no move towards universal tax assessment. CIPFA noted that such a move would probably be necessary if the liability on investment income were to be treated as anything other than a national or an assigned local tax. Given the number of variables involved, it was therefore not possible at this stage to quantify fully the costs of a LIT.

Start-up costs and timing

5.20 Beyond the annual costs of running a LIT, the one-off set-up costs would need to be considered. CIPFA's initial broad estimates suggested that the introduction of a system based on PAYE and self-assessment would cost around £330 million, primarily from the costs of setting up and populating a database of individual taxpayers with their address for the purposes of local taxation, and upgrading IT systems. (If council tax were abolished at the same time, CIPFA also estimated that staff severance and restructuring costs might cost something like £70 million on top.)

5.21 CIPFA similarly estimated that the timetable for completing legislative requirements, preparing systems, consulting and testing would be a minimum of four years. This would allow two years to complete legislative requirements, one year for systems preparations and, in parallel, two years for consultation and testing.

The implications for business

5.22 Levying a LIT through PAYE would involve an additional burden on employers. The size of this burden would depend on the complexity of the precise form of LIT, and it would also fall differently on different types of employer. Larger firms, and firms in metropolitan areas, would tend to have employees living in a larger number of separate local authorities. They could therefore be expected to be dealing with a larger number of local tax rates, thus increasing the complications. On the other hand, smaller firms, which are less likely to use electronic data interfaces and run manual payrolls, would face a particular set of difficulties arising from the need to use a number of different tax tables. However, CIPFA argued that it would be possible to reduce the complexity and consequent burden on employers by limiting the variable local LIT to no more than five fixed rates which could be incorporated within the existing taxcode system. In consultation with representatives of employers, CIPFA estimated an additional cost to business of around £110 million per year arising from the introduction of a LIT. This compares with a current annual cost to businesses of around £800 million to administer the PAYE system (as estimated by the University of Bath).

Investment and savings income

5.23 One important issue highlighted by CIPFA concerned the treatment of forms of income not currently covered fully by the PAYE system, notably income from savings, dividends and other investments. CIPFA argued that, although such income represents only a small proportion of total income tax, implementing a system of locally variable taxation for it would be extremely expensive and intrusive in view of this relatively small yield.

5.24 Some commentators have argued that in order to ensure fairness and accountability such income would need to be taken within the scope of a LIT. In this case, arrangements would need to be introduced to deduct a variable LIT element from savings interest (on which a 20% flat rate is currently deducted by banks and other financial institutions for all taxpayers, with higher rate taxpayers paying the additional liability through self-assessment returns) and company dividends (which are not currently subject to any deduction at source). This would be complex and expensive to implement. There would also be some difficulties in matching investment income to individuals, for example with nominee and joint accounts.

5.25 A system of universal tax returns for all taxpayers would be one way of tackling this issue, but this would involve significant and far-reaching changes to the whole tax system, and would have high running costs. CIPFA's broad estimate is that it could add £1.3 billion to the current collection costs of income tax. It would also be at odds with the Government's policy that only those individuals who need to be part of the self-assessment system should be; and with recent changes to increase the number of taxpayers for whom all tax liability is deducted at source.

5.26 The administrative challenges could be lessened if a flat rate surcharge on all investment income were introduced which could then be distributed to local authorities through the grant system or by some other means. This is the conclusion that the Layfield Committee came to when it considered the same issue. However, this approach, while simpler, would still involve increased administrative costs and would have the disadvantage of providing no link between the amount paid and the LIT rate set by an individual's local authority. It would also mean that companies would have to introduce a system of withholding on their dividends, as there is currently no mechanism to collect the surcharge. The impact on the savings and investment markets would also need to be considered.

5.27 CIPFA argued that it was not essential for additional tax to be levied on investment income. Their proposition was that, leaving aside the (limited) variability that their model proposed for the LIT on PAYE earnings, the move to a LIT, balanced by a reduction in national income tax, amounted only to a transfer of existing taxation from central to local government. In overall terms, no additional tax was being levied and the balance between the taxation of earned and unearned income would remain unchanged. It could therefore reasonably be argued that investment income did not need to be separately brought into the equation. Indeed, CIPFA argued that, because of the likely perverse impact on investor behaviour, it would be inappropriate to consider a tax on investments as anything other than a source of national revenues.

The impact on individuals

5.28 A national LIT would affect 30.7 million taxpayers across the UK – 5.7 million more than council tax payers. Estimating the amount of LIT that individual taxpayers would pay would clearly depend above all on the global amount that it was envisaged the tax would raise, and on the way it was applied to particular types and amounts of income. But other factors would also apply, including the extent to which the taxbase was equalised between local authority areas.

5.29 At one extreme, in the simplest form of assigned LIT suggested in response to the Review's consultation, an amount of the revenues currently raised as national income tax would merely be earmarked for, and passed on to, local authorities. There would be a commensurate reduction in the revenue support grant (RSG) paid to local authorities by the Government, with national income tax reduced so that individual taxpayers should not notice any effect on the total of income tax they paid.

5.30 CIPFA have estimated that (on 2003/04 figures and ignoring behavioural effects) a rate of about 4 pence in the pound on all rates of income tax would be equivalent to the amount of revenue currently raised in council tax. If the LIT were levied on standard rate tax only (which would be a simpler but less progressive solution), the equivalent figure would be around 6 pence. Without detailed work on how the equalisation system would operate it is difficult to give precise numbers on the extent of regional variation. However, adopting simple equalisation assumptions, based on the current grant system, CIPFA suggested that actual local poundages might range between 3.2 pence and 6.5 pence.

5.31 In the particular case of their 'possible model', CIPFA suggested that a banded system of LIT might include five rates of LIT – at, say, 2 pence, 2.5 pence, 3 pence, 3.5 pence and 4 pence in the pound, with a commensurate reduction of 3 pence in the pound for national income tax.

5.32 According to CIPFA's analysis, if LIT were to replace council tax, the effective tax rate for individuals on average incomes might rise from 15.5% to 17.9% and from 26% to 30% for individuals with incomes three times the national average. The analysis suggested that lower income groups, particularly pensioners, single parent families and households with at least one other person dependent on a single earner would tend to gain most from a switch from council tax to LIT, and the single employed and households with two or more earners would be least likely to benefit.

5.33 In the case of a LIT which *replaced* council tax in particular, the effect of the LIT on many lower income individuals would also be affected by the interplay with other benefits. CIPFA estimated that, without protection, the very poorest could be worse off with a LIT than with council tax. We were not able to investigate the complex issues involved here, but they are clearly another example of a crucial area which would need further detailed examination.

Other practical issues

5.34 Beyond the main form and the costs of any system of LIT, CIPFA noted that there would be a wide range of other practical issues to consider.

Geographical liability

5.35 Since liability to tax would depend directly on where a taxpayer lived, there would be a need to establish and maintain a comprehensive list of taxpayers and their addresses.

5.36 One would need to consider how to deal with those who would move between authorities and with the financial consequences of such moves for the authorities concerned, with a balance to be struck between on the one hand simplicity and ease of administration, and on the other fairness and accountability. There would also be a need to cater (for example) for those in highly mobile jobs and those with second homes.

5.37 CIPFA's 'possible model' suggested that a simple way of dealing with many of these issues would be to determine tax eligibility for the year on the basis of residence on one particular day of the year. This approach would avoid the need to track taxpayers' residence throughout the year, although it would of course dilute authorities' accountability to some frequently mobile taxpayers. CIPFA suggested that this date might conveniently be 10 October before the start of the tax year, which coincides with the date for registration of residence for electoral purposes. They recognised that this would create an extremely challenging timetable for the information to be processed in time for IR's main tax coding run, and further work would be needed to see whether this would be achievable. However, any choice of date would in a sense be arbitrary and might raise its own particular set of problems.

The local authority budget cycle

5.38 There would be important implications for the local authority budgeting cycle of an annually-assessed tax. If employers were to be in a position to make LIT deductions from pay from the beginning of the tax year, IR would need by then to have received and processed local LIT precepts and notified taxpayers and their employers of their tax codes. CIPFA's work showed how, to achieve that timetable, the present local authority budgeting cycle, which ends on 11 March, would need to be advanced. So, in turn, would the central government grant settlement cycle.

Increasing simplicity through bands

5.39 The practical problems of every billing and precepting authority setting its own rate of LIT, even within nationally determined limits, would be significant. This problem would be felt by both IR and employers, but (as suggested above) most acutely by smaller employers operating manual payrolls who would be required to manage a complex set of tax tables.

5.40 For this reason CIPFA suggested a simplification of the system proposing a limited number of LIT bands. They also suggested that the IR could be responsible for estimating the LIT taxbase for each authority and could pay local authorities on the basis of this estimate, to avoid local authorities facing difficulties arising from variations between local taxbase estimates and actual revenues received. Overall surpluses and deficits would be managed by the IR/Treasury within the overall national collection fund.

5.41 CIPFA concluded that a choice from a limited number of bands would mean that local authorities would have to fine-tune the amount of revenue they raised by balancing the precise budget requirement from the council tax, for which the demand (or precept) could be specified very precisely.

Increasing simplicity through restricting the number of local authorities involved

5.42 CIPFA suggested that another way of reducing some of the administrative complications of a locally set LIT would be to restrict the power to set a LIT to higher and single-tier authorities, as these authorities account for most local authority expenditure (in shire areas, the upper-tier counties are typically responsible for over 90% of local authority expenditure). This would of course be possible only if the LIT were to supplement council tax rather than replace it. They argued further that such a system would lead to a reduced number of in-year cross-boundary moves by individual taxpayers (because the areas within which moves took place would be larger) and a greater probability of other areas sharing the same LIT rate within a restricted number of LIT bands.

'Cliff edges'

5.43 As in the case of the possibility of a regional dimension to council tax, a LIT raises the potential problem of increasing 'cliff edges', whereby taxpayers living either side of a local authority boundary might pay widely different rates of tax. These might be created both across local authority boundaries, where neighbouring authorities set significantly different rates of LIT, and, if a LIT were not to be introduced across the UK as a whole, across national boundaries.

Equalisation

5.44 There are significant geographic variations across the country in the income tax base. Similar variations already exist in the case of the council tax base. In this case the RSG system aims to equalise away these differences by recognising variations in the local resource base in the amounts distributed in grant. In the case of income tax, the geographic variations are even more marked; compared with variations in the council tax base, variations in the income tax base in England are on average over two percentage points greater in London and the South East, and to a lesser extent the eastern region, and by up to one percentage point lower in the other regions.

5.45 It is assumed that appropriate equalisation would be required in response to this variation, too, although it has been suggested that, if a LIT were to take the form of a supplement to council tax, there might be a case for not attempting to equalise as fully between areas as is currently the case with council tax and the RSG system. Either way, a requirement for equalisation would mean that there would be a natural limit to the amounts which could be raised by way of a LIT before central grant to authorities with the largest income tax base would be reduced to zero. Beyond that point, the RSG system could not be used to achieve full equalisation, and to go any further might require direct resource transfers between authorities to ensure equity.

Assessment of pros and cons against Review principles

5.46 It is clear from CIPFA's work that LIT is a complex issue and there are a large number of as yet unresolved difficulties. We recognised that we were not in a position to examine these in the depth necessary to provide definitive answers. However, we concluded that a broad assessment of the case for and against a LIT could be made along the lines below.

5.47 Except where otherwise stated, the following paragraphs assume that local authorities would be able to vary the rate of a LIT.

5.48 ***Impact on balance of funding:*** As a replacement for council tax (and assuming that the total amount raised remained unchanged) a LIT would have no significant impact on the overall balance of funding. This position would, however, be subject to the effect of future buoyancy in revenues increasing the relative size of the tax take within the total envelope of local authority income. As a supplement to council tax, a LIT could be used to achieve a significant shift in the balance of funding with any reduction in central grant resulting in a commensurate reduction in national taxation.

5.49 ***Local accountability:*** A variable LIT should increase local accountability to taxpayers if it were introduced as a supplement to council tax. This is, however, subject to the important rider that, unless clearly presented and explained, a more complex funding system with two separate tax revenues might in practice be harder for taxpayers to understand, and therefore weaken accountability – if taxpayers paid both council tax and LIT, this might give the impression that they were paying twice for services. A LIT would also be less visible than council tax.

5.50 If LIT were used to effect a shift in the balance of funding, there would be a need to explain clearly that any increase in local taxation would be accompanied by a reduction in central government grant and therefore national taxation. The accountability of a LIT to taxpayers would consequently be enhanced if the tax were limited to all-purpose authorities, and could thus be identified with the personal services to which the major proportion of local expenditure is applied.

5.51 ***Progressivity:*** A LIT would be more progressive to income than council tax. The degree of progressivity would depend on the income tax bands on which the LIT was levied – if it were confined to the standard rate of tax, it would be less progressive than if it were levied on the higher rate bands.

5.52 The impact on those who would gain or lose from a LIT would need careful consideration. Some groups of taxpayers (e.g. pensioners and single parent families) would tend to do much better out of a LIT than others (e.g. the single employed and households with two or more earners). It would be important to consider the impact on such groups in the context of the wider tax burden.

5.53 There is a special issue with regard to investment income. While there are practical arguments in favour of excluding this, there is nevertheless a risk of perceived unfairness if it was not subject to the LIT.

5.54 ***Evenness of distribution:*** Compared to the council tax base, the income tax base is less evenly distributed across the country. The equalisation process achieved through the distribution of RSG would need to take account of this. The wider variation of the taxbase would also be reflected in wider local variations in the balance of funding and gearing, and therefore in the differential capacity of individual authorities to raise more tax locally.

5.55 ***Buoyancy:*** LIT would provide local authorities with the same buoyancy (in that part of their revenues) as national income tax revenues, reflecting economic growth. These are significantly more buoyant over time than council tax revenues. Unless compensated for by the national system of equalisation, downturns in local economies would fall to the local authority concerned to sustain (though this effect would be mitigated in the short term because CIPFA's model proposes the IR allocating tax revenues to local authorities on the basis of estimates rather than actual receipts).

5.56 ***Predictability:*** The yield from a LIT would be less predictable than that from council tax. Even relatively small variations between a local authority's prediction of LIT receipts and actual revenue raised could have significant implications for its finances, particularly over a run of years, but this could in part be mitigated by distributing revenues to authorities on the basis of estimates and carrying surpluses and deficits on the yield within the national LIT collection fund.

5.57 Again, there are special issues connected with investment income and the incentives that imposing (or not imposing) a LIT on this kind of income might have.

5.58 ***Collectability:*** Some of the complexities in collecting a variable LIT, together with the potential costs of doing so, are highlighted earlier in this chapter. Although the costs of collection would undoubtedly be considerable, given the number of different factors involved, it is impossible to estimate these reliably at this stage. It would be simpler and cheaper for the IR to collect the tax rather than local authorities themselves. The system could be made simpler and cheaper still if the LIT were restricted to upper- or single-tier authorities, and if the rates levied were restricted to a small number of bands. However, this would imply some loss of accountability. In any event employers would face extra compliance costs. Broadly speaking, a LIT would be harder to enforce and collect than a property-based tax such as council tax.

Conclusion

5.59 In the light of CIPFA's advice, we have reached the following main conclusions:

- an assigned LIT would not achieve any shift in the balance of funding although it would improve buoyancy (but at the cost of predictability and equalisation) and might provide a stepping stone to a variable LIT if such an option were to prove feasible and desirable;
- as noted in Chapter 3, council tax has important advantages and there is a strong case for retaining it, subject to detailed consideration of options for reforming it. Any further work examining the pros and cons of LIT should proceed on the basis that it is a supplement to, not a replacement for, council tax. At any rate, simply replacing council tax with a LIT would not in itself shift the balance of funding;
- a supplementary LIT would be progressive to income and provide a buoyant yield and is capable of shifting the balance of funding significantly;
- a variable LIT should increase local accountability, subject to the important rider that, unless clearly presented and explained, a more complex funding system might be harder for taxpayers to understand;
- the effects of any LIT on individuals or employers would also need to be examined with great care. There are a number of potentially serious risks and disadvantages that would need to be considered in detail, including the potential additional costs that the system could impose;
- LIT could be potentially complex to administer. CIPFA's work set out a relatively simple form of LIT, although in practice there may be a trade-off between simplicity on the one hand and equity on the other;
- building on CIPFA's work, considerable further work would be required to address the significant technical and administrative difficulties associated with a LIT, including the burden on employers, before firm conclusions could be reached on its feasibility or desirability.

Chapter 6
Other Options

6.1 The final option which we decided to consider was a selection of smaller taxes and user charges which could be introduced either individually or in combination, and included:

- 'localising' existing national taxes (i.e. giving councils the right to vary the rate and keep the proceeds), e.g. on Vehicle Excise Duty (VED) or Stamp Duty on houses;
- introducing new taxes, e.g. local sales tax, land value taxes, tourist bed taxes, or green taxes;
- 'user charges', e.g. on services, utilities' street works or road users.

6.2 Other options such as reformed council tax, business rates or local income tax have a much higher actual or potential yield than any one of these smaller taxes and charges. However, we decided to consider whether any of these smaller taxes, either individually or in combination, could replace or supplement council tax.

6.3 During the course of the Review a number of other options and issues were mentioned, particularly during the public consultation. These included total funding of local government by central government.

6.4 In addition, a number of issues such as local government efficiency were raised. Whilst these were not central to the Review's remit, we did consider how they related to the main issues and whether they might form part of the solution.

Smaller taxes and charges

The views of consultees

6.5 Many consultation responses were enthusiastic about introducing one or more of the smaller taxes and charges listed above. Many local authorities agreed with the LGA in welcoming the charging and trading powers given to local authorities by the Local Government Act 2003 and said that more charging powers would further improve their position. Some suggested specific charges (e.g. on planning fees, utilities' street works or food hygiene inspections).

6.6 The general principle of taxes where the consumer of a service pays for it was quite popular, including in responses from the public. Research on public attitudes by NOP World (see Annex C) also suggested that the public could accept such 'user charges', as they seemed fair and transparent. Suggestions in this category did not only include charges (as above), but also a tourist bed tax, green taxes, and a local sales tax or levy on VAT. Many asked for the latter to be looked at, but showed concern about the negative effects of local sales taxes, which would be regressive and would lead to problems with neighbouring areas charging different prices. Other possible taxes mentioned included localised Stamp Duty, allowing authorities to retain receipts from VED and a land value tax (to allow local benefit from developments that increase land value).

6.7 There were some concerns about these taxes in general, despite their advantages. Although they would give authorities more flexibility and buoyancy, some responses argued that they could also make the system more complex and therefore unaccountable, especially if assigned to more than one tier of local government. And, while local authorities and others saw them as helpful, no responses saw any of these smaller taxes as an answer to the problems of high council tax bills or gearing.

LGA papers

6.8 The LGA showed support for consideration of other smaller taxes and charges in their consultation response and also in their published paper *The Balance of Funding – A Combination Option* of January 2004.[1] In the light of this, we invited them to present evidence on this 'basket option'. They did so in two papers.

6.9 The first paper[2] discussed the whole range of taxes and charges that had been identified as being of potential interest to the Review. These options included:

- localisation of Stamp Duty on houses;
- other new taxes such as local sales tax, site value taxes and green taxes;
- various user charges, such as road user charges.

6.10 In some cases charging powers already exist (e.g. congestion charging), but most of the options considered would require legislation. We decided that some of these should be rejected and that most of these did not need to be considered in detail within the Review.

6.11 However, we did invite the LGA to present further evidence[3] on two options – a localised VED and a local tourist bed tax. The LGA suggested giving local authorities an incentive to deal with the problem of abandoned and unlicensed cars by allowing them to retain some VED revenues locally. They also suggested the possibility of introducing optional tourist taxes; it would be open to authorities who adopted such a tax to use the proceeds to help pay for tourist promotion following local consultation about the tax rate.

Conclusion

6.12 We welcomed the LGA papers as providing a thorough analysis of the issues. Although some of these smaller taxes and charges might be pursued for particular policy reasons and might improve links with stakeholders, we have concluded that none of them could achieve a significant shift in the balance of funding. The case for and against each of these options should be judged on its own merits rather than on any impact it might make on the balance of funding.

1 Formally presented to the Review later as BoF 21: The Balance of Funding – A Combination Option

2 BoF 23: Other Taxes and Charges

3 BoF 26: Vehicle Excise Duty and Tourist Taxes

Total central government funding of local government

6.13 This suggestion was made predominantly by some pensioners' groups and individual members of the public. It proposed that council tax be abolished and that all the revenue needs of local government be met by a grant from central government. Some suggested that local government should draw up a spending plan for approval by central government. Responses focused largely on how the extra money to pay this grant should be raised. Most suggested that at least part of it should come from an increase in national income tax. Others suggested that it should come from a mixture of an increase in income tax and an increase in VAT.

Conclusion

6.14 Total central government funding would remove issues about gearing and equalisation. However, it would be entirely counter to the idea of local accountability. Councils would have no flexibility to raise taxes. All this would limit local democracy and place additional burdens on central government. It would also set England apart as the only major developed country with local government entirely funded from central sources.

Other issues

6.15 During the course of its examination of the main reform options proposed by consultees, we noted a number of wider issues related to local government finance, some of which had also been raised in the public consultation. These included:

- the scope of local government, and the appropriate balance of responsibilities between it and central government;
- new burdens required of local government by central government;
- the efficiency and effectiveness of local government.

6.16 It was clear to us that all of these were important issues. If the scope of local government (i.e. which services it pays for) were less, its revenue needs would also be less. The opposite would be true if local government had more responsibilities. New burdens could reduce the flexibility of local councils over how they spent the money they got from local taxes or central grant. The efficiency of local government determined whether they spent the money they did raise effectively, and thus whether further pressure was placed on council tax. Efficiency could be affected by a variety of factors, for example, a trend towards greater ring-fencing of central grant which often required greater bureaucracy at local government level.

Conclusion

6.17 We decided that all these issues were wider than the remit of the Balance of Funding Review. On the role of local government, central and local government shared some views and differed on others, but were working on these issues separately in other forums. Central and local government were also working together to encourage efficiency and good practice by a variety of means, notably the Gershon Review of public sector efficiency.

Annex A
Steering Group Membership

Rt Hon Nick Raynsford MP *(Chair)*	Minister for Local and Regional Government, Office of the Deputy Prime Minister (ODPM)
Councillor Sir Jeremy Beecham	Chair, Local Government Association (LGA)
Sir Howard Bernstein	Chief Executive, Manchester City Council
Sir Brian Briscoe	Chief Executive, LGA
Councillor Peter Chalke CBE	Leader of the Conservative Group, LGA
Councillor Chris Clarke OBE	Leader of the Liberal Democrat Group, LGA
Andrew Dilnot CBE	Principal, St. Hugh's College, Oxford
Steve Freer	Chief Executive, Chartered Institute of Public Finance and Accountancy
John Healey MP	Economic Secretary to the Treasury, HM Treasury
Phil Hope MP	Parliamentary Under Secretary, ODPM
Bob Linnard, then Lindsay Bell (from March 2004)	Director of Local Government Finance, ODPM
Alasdair McGowan	No.10 Policy Unit
Professor Elizabeth Meehan	Director of the Institute of Governance, Public Policy and Social Research, Queen's University, Belfast
Lucy Neville-Rolfe	Group Director, Corporate Affairs, Tesco plc.
Dr Jeffrey Owens	Head of Centre for Tax Policy and Administration, Organisation for Economic Co-operation and Development
Darra Singh OBE	Chief Executive, Luton Borough Council
Dr David Smith	Director of Finance and IT, Wigan Metropolitan Borough Council

Professor Gerry Stoker	Professor of Politics, University of Manchester and Chair, New Local Government Network
Heather Wakefield	Local Government National Secretary, Unison
Councillor Milner Whiteman OBE	Leader of the Independent Group, LGA
Dr Stewart Wood	Economic Adviser on Local Government, HM Treasury
Andrew Morrison, then Andrew Allberry (from September 2003) *(Secretary)*	Divisional Manager, Taxation, Valuation and General Policy Division, ODPM
Mike Chown *(Observer)*	Head, Local Government Finance Division, Welsh Assembly Government

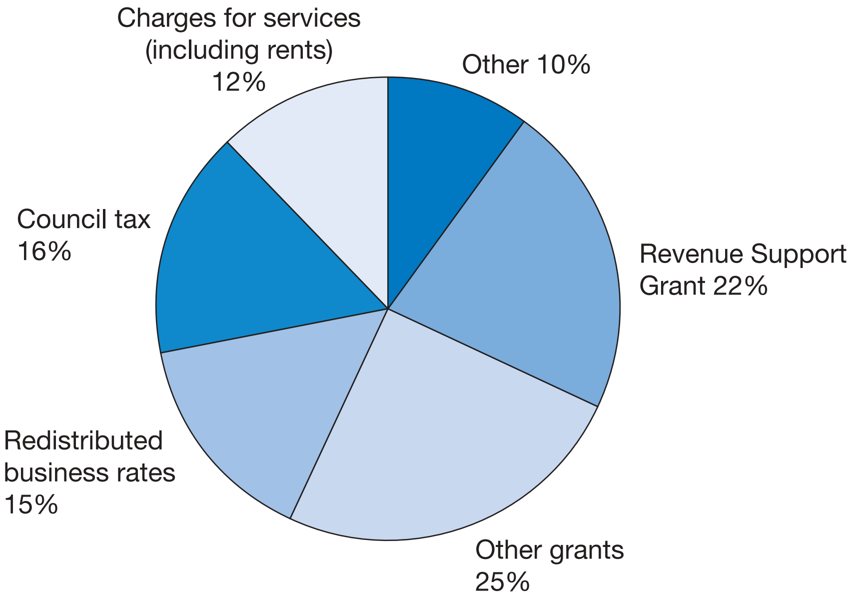
Annex B
Background Data for the Review

Local government income

B.1 The total income of local government in England in 2001/02 was just under £98 billion. This can be divided into three broad categories: capital, revenue and housing. The Review was concerned with revenue income. This comes from three main sources: government grant, redistributed business rates and council tax. There is also significant revenue from fees and charges.

B.2 Total government revenue grants, excluding those where local authorities simply act as a conduit for funds to third parties, totalled approximately £31.4 billion in 2001/02. The redistributed business rate provided income of £15.1 billion. Council tax, including Council Tax Benefit grant, brought in approximately £15.3 billion. Added to this is approximately £9 billion received from sales, fees and charges (this covers a wide range of activities, from parking fines to planning application fees, much of it limited to cost recovery of services provided) and £3 billion from council rents.

Figure B.2: Breakdown of local authority income 2001/02



Source: Local Government Financial Statistics 14 (2003)

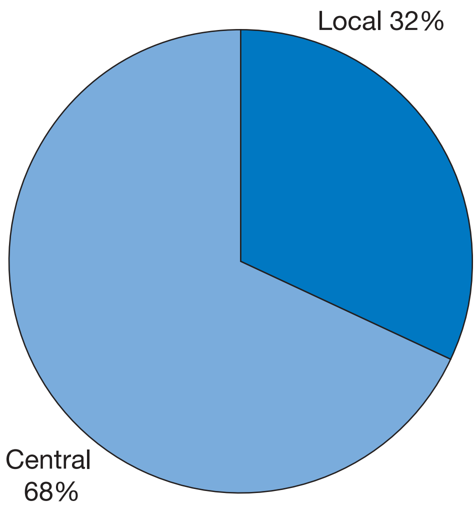
The balance of funding

B.3 The balance of funding is simply the proportion of money provided centrally as against the proportion of money raised locally. The headline figure, though, varies sharply, depending on how widely the net of local government income is drawn. It is also not always straightforward whether funding should be defined as local or central. Council Tax Benefit grant (worth nearly £2 billion in 2001/02) is the key case in point.

Throughout this report it is included as local income on the basis that the amount received is determined by local budget decisions.

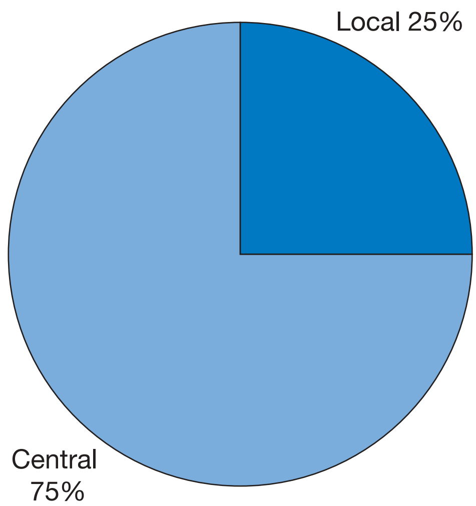
B.4 Taking income as described in Figure B.2, the balance of funding for 2001/02 is as shown in Figure B.4a. More commonly, though, the balance of funding is measured taking account only of revenue grants, business rates and council tax. This produces the more familiar central and local proportions illustrated in Figure B.4b.

Figure B.4a: Balance of funding (using figure B.2 definition)



Source: Local Government Financial Statistics 14 (2003)

Figure B.4b: Balance of funding (Grants/business rates to council tax)



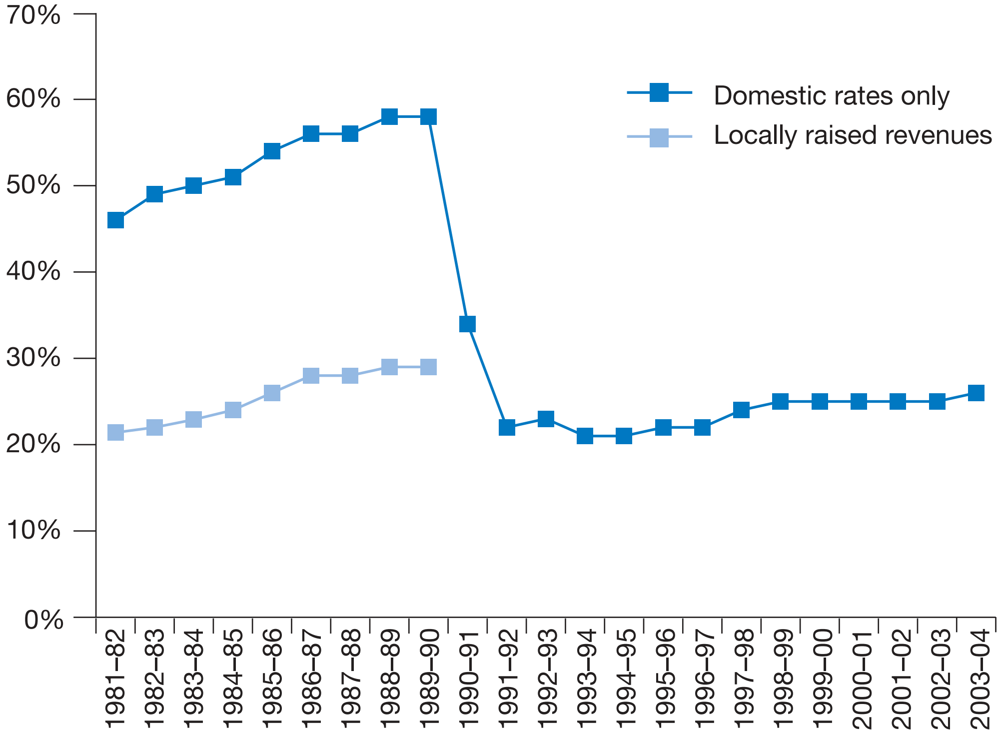
Source: Local Government Financial Statistics 14 (2003)

B.5 For simplicity, the rest of this chapter looks at the balance of funding on the basis illustrated in Figure B.4b. Local income is council tax and Council Tax Benefit grant. Centrally provided income is government grant and the redistributed business rates.

The historical picture

B.6 Figure B.6 illustrates the proportion of revenue expenditure funded locally over the last 20 years. The large fall in the middle of the graph reflects the nationalisation of the business rate from April 1990. This serves to conceal the peak that would have otherwise been reached in 1990/91 under the community charge regime. In this year 34% of revenue was raised locally. Otherwise, excluding business rates, the figure has stayed at between 20% and 30%. Establishing a consistent data series further back is problematic. Looking at Great Britain as a whole, however, suggests that between the late 1940s and the mid-1970s, the value of rate receipts against central government grant declined from 50:50 to less than 40:60.

Figure B.6: Balance of funding



Source: Local Government Financial Statistics 14 (2003)

Regional and local variation

B.7 The balance of funding varies greatly between regions and indeed between individual local authority areas. The level of deprivation is the key driver of this variation. Authorities in more deprived areas will tend to have both less capacity to raise council tax revenue and a greater need for resources to meet costs associated with disadvantage. The local government finance system adjusts for both these factors by providing more grant.

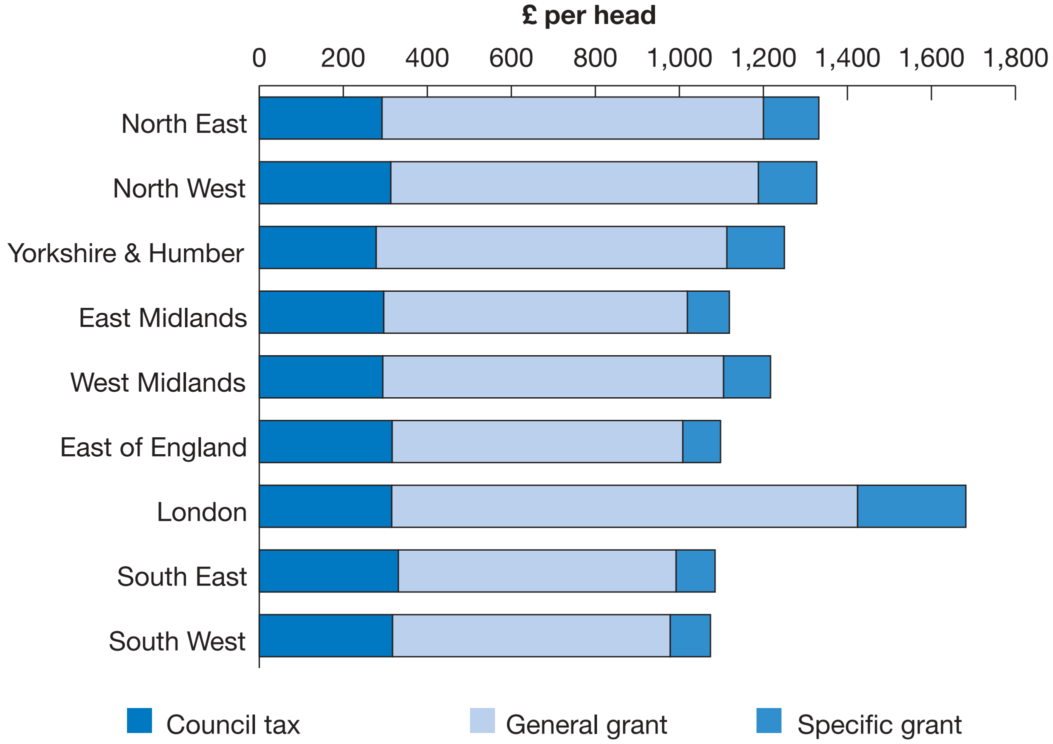
Figure B.8a: The relationship between deprivation and the balance of funding

	Index of multiple deprivation 2000[(a)] (Average ward score by region)	Central funding[(b)] 2001/02	Local funding[(b)] 2001/02
South East	15	70%	30%
East	18	71%	29%
South West	20	71%	29%
East Midlands	21	74%	26%
West Midlands	23	76%	24%
Yorkshire & Humberside	27	78%	22%
London	29	81%	19%
North West	30	76%	24%
North East	35	78%	22%
Total England		**75%**	**25%**

Sources: (a) Indices of Multiple Deprivation (2000)
(b) Calculated using Table C3c, Local Government Financial Statistics 14 (2003)

B.8 As the table at figure B.8a shows, London fits less well into this general pattern. Some costs in the capital are exceptionally high. In 2001/02, London's spend per head was 53% above the average for social services and 79% above the average for police. Grant levels per head are correspondingly much higher in the capital. Differences in council tax per head between regions are substantially smaller.

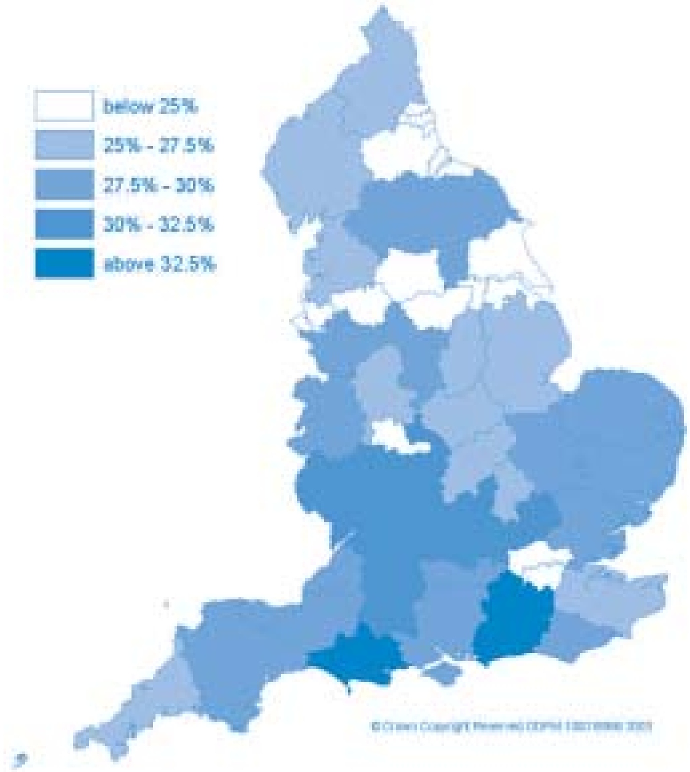
Figure B.8b: Sources of revenue funding by region 2001/02



Source: Local Government Finance Statistics 14 (2003)

B.9 Figure B.9 illustrates the extent of variation in the balance of funding across England by showing all first-tier authorities (in areas where there are both county and district councils, only the county is shown) in one of five balance of funding bands.

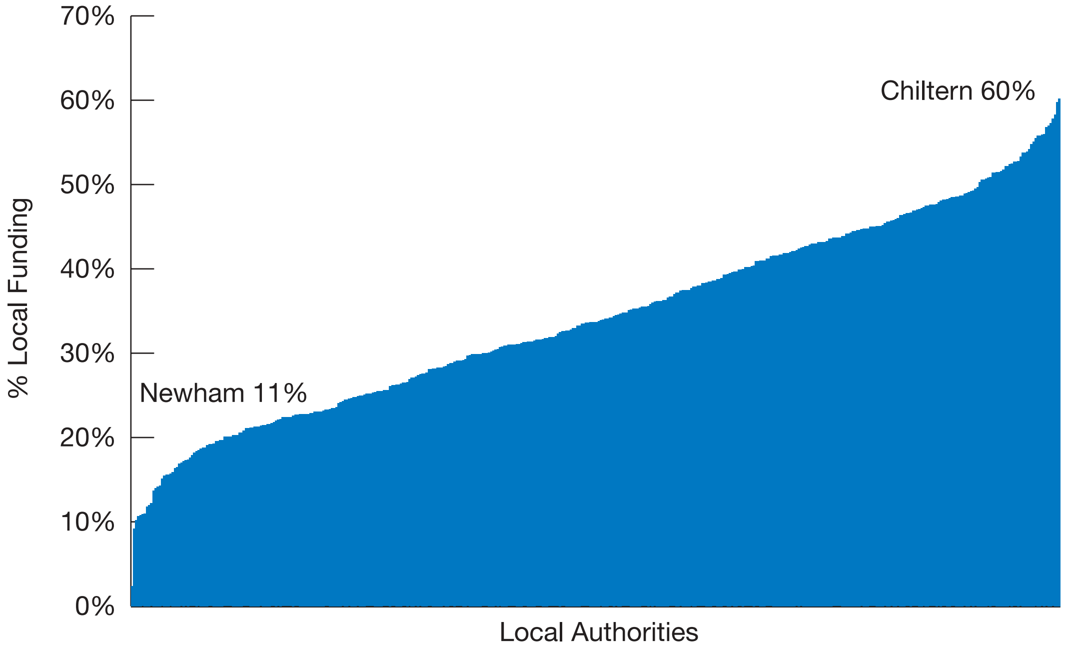
Figure B.9: Proportion of revenue funded through council tax 2001/02



Source: Local Government Finance Statistics 14 (2003)

B.10 The extent of variation in the balance of funding is illustrated even more sharply by figure B.10. At one extreme, some London authorities (Newham, Wandsworth, Westminster and Tower Hamlets) raised less than 11% of their funding for revenue expenditure through council tax in 2002/03. At the other end of the scale, the figure was 60% in Chiltern.

Figure B.10: Balance of funding 2002/03

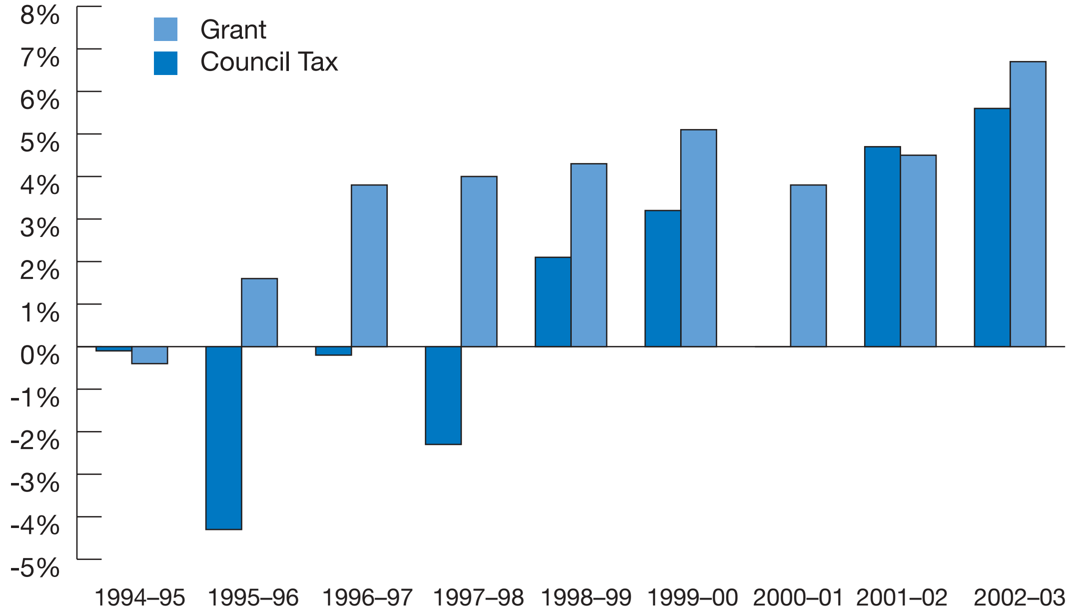


Source: Revenue outturn 2002/03 returns (ODPM)

Pressures on Local Government Finance

B.11 The Balance of Funding Review takes place within the context of significant growth in expenditure on local services in recent years.

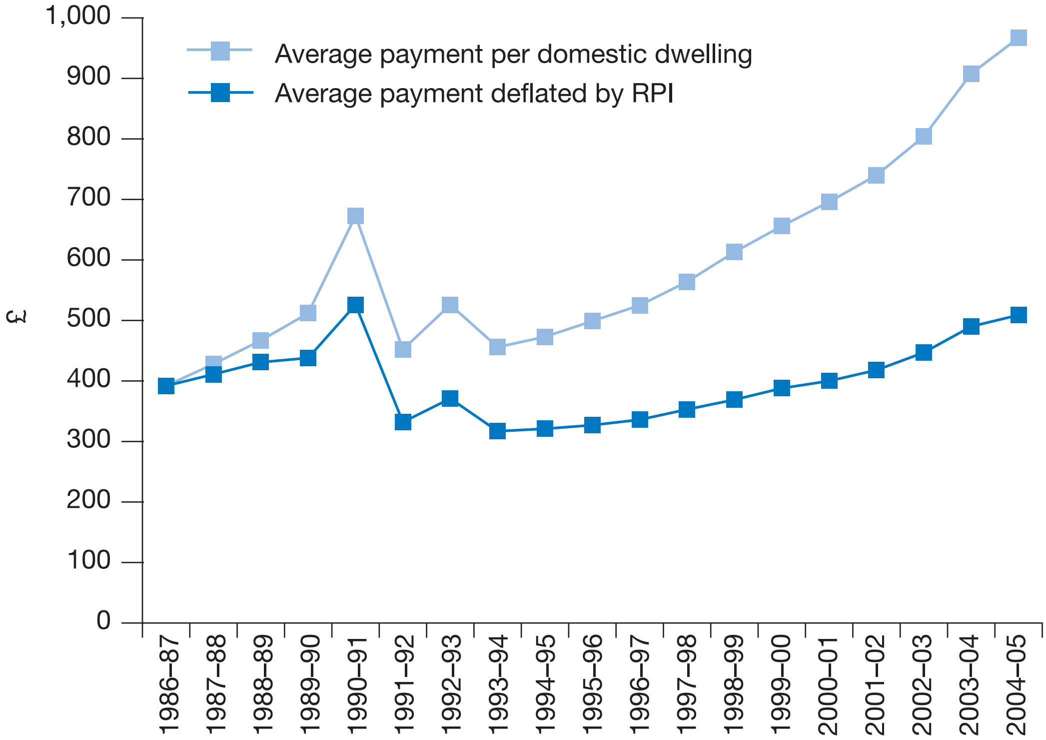
Figure B.11: Annual real terms increases in central government grant (adjusted) and council tax 1994/95 to 2002/03



Source: Settlement and Local Government Financial Statistics 14 (2003)

B.12 In the same way that the Layfield inquiry of the mid-1970s took place in the context of rapidly rising rates bills, so the Balance of Funding Review started in 2003/04 at a time of particularly sharp increases in council tax bills. However, the increase has been greatly reduced in 2004/05.

Figure B.12: Average local tax per dwelling 1986/87 to 2004/05 in cash and real terms



Source: Local Government Financial Statistics No. 14 and BR forms

Annex C
Research of the Review

C.1 Four research projects were carried out for the Review. The research findings and our conclusions are summarised below. Reports of each project are available on ODPM's website.[1]

Project 1: Balance of funding and turnout

C.2 It is generally held that the more people that vote in local elections, the greater the democratic legitimacy of a council to make decisions for the benefit of its community. When the Review started, many local authorities held a view that there could be a direct connection between the balance of funding and local election turnout. We commissioned research by Plymouth University to find to what extent this was correct.

C.3 Professor Colin Rallings presented the results of this project. Plymouth University had carried out quantitative analysis, using a detailed statistical model developed for previous research, into factors underlying turnout in local government elections. The model drew on turnout data from 1973 to 2003, combined with data from a range of socio-economic, political and structural variables. Time-series balance of funding and other financial and performance data were fed into the model to test to what extent they could independently explain variation in voter turnout, while controlling for other factors.

C.4 The results of this research suggested that, when allowance is made for the social, political and structural context, the balance of funding and other financial variables do not add any further explanation of variations in turnout in most councils. (There was a statistically significant association in unitary authorities, but it only accounted for a relatively small proportion of the explanation of variance; there might be other factors underlying this finding; and the data derived from a particularly limited series of election results.)

C.5 Professor Rallings argued that previous research which had suggested a close link between balance of funding and turnout was time-limited, did not allow for local authority analysis, and did not address a potential 'poll-tax' blip. Such a causal relationship would require both that the public know, and are driven by, the balance of funding and that any connection is not due simply to other factors, such as deprivation.

C.6 We accepted Professor Rallings's conclusion that the available evidence did not demonstrate a direct connection between the balance of funding and local election turnout.

1 The reports are available at http://www.local.odpm.gov.uk/finance/balance/rsg.htm, http://www.local.odpm.gov.uk/finance/balance/bof20.pdf, http://www.local.odpm.gov.uk/finance/balance/bof22.pdf

Project 2: Public awareness and attitudes

C.7 To determine public awareness and attitudes to a wide range of issues addressed by the Review, we commissioned NOP World to hold a series of deliberative focus groups.

C.8 Twelve focus groups were held, encompassing a total of 92 people from different regions, ages and socio-economic groups. They covered rural and urban areas, areas with relatively high and low local funding, two-tier authority areas, unitary authority areas, metropolitan districts and London. Focus groups lasted at least 150 minutes, and investigated people's views both before and after they had been informed of the reality.

C.9 Although there was increased media coverage of council tax issues during the research period, the researchers concluded that this had had no apparent influence on people's responses.

C.10 The results (for all groups and types of person) indicated that:

- most people knew little about the balance of funding. When asked to guess, most assumed that councils raised 70-80% of their funding locally through council tax. They were surprised to learn the true position, but claimed that it did not matter much provided that there were effective checks and balances on the way the money was spent;
- many people expressed concern about recent rises in council tax. That was the case across all ages and socio-economic groups, but especially the young, people on low incomes and pensioners;
- once the system was explained, people thought that its benefit was that money was distributed fairly across the country. In the case of education, health, social services and transport it was critical to have national standards with everyone receiving the same level of service wherever they lived. For other services local variations were acceptable;
- there was no evidence that the current funding system had any effect on voter behaviour. Older people voted because they saw it as their civic duty. However, people under 30 came across as uninterested in voting in local elections, claiming that no one had explained why they should vote or what difference it would make;
- the priority for most people was to see where their money was being spent. They wanted central government to retain some control over local expenditure;
- provided that there were national standards for key services (as mentioned above) and minimum standards for services such as refuse collection, street cleaning, street lighting etc, and provided that local residents were consulted, people were happy for local residents to choose to pay for additional local services – preferably on a 'pay as you go' basis. Potential new taxes (e.g. local income tax, local sales tax) were not mentioned spontaneously. When prompted, people could not grasp how these taxes might operate.

C.11 We accepted these conclusions, which were broadly borne out by other research based on more quantitative surveys, for example research for the Office of the Deputy Prime Minister (ODPM) by the National Centre for Social Research.

Project 3: Relationship between the balance of funding and efficiency

C.12 ODPM identified a need to test the hypothesis that more highly geared authorities (i.e. those that were more dependent on central grant) were more efficient because they had a stronger incentive not to increase council tax. ODPM commissioned an in-house research project. A basic multiple regression modelling exercise was undertaken which sought to explain local authority performance (as a proxy for efficiency) according to a range of independent variables, including gearing ratio and level of Band D council tax.

C.13 The project found that any association between balance of funding and efficiency was weak and accounted for only 2% of any explained variation in relative performance. Moreover, the association was negatively correlated, in that those authorities which depended more on local funding performed slightly better. However, that might be due in part to their relative affluence. The research had identified a strong link between high gearing and deprivation.

Project 4: International lessons

C.14 We discussed proposals for research projects on how analytical and applied international experience and lessons could support the Review. We agreed only to commission priorities, given the Review's limited budget and time.

C.15 We needed a synthesis of the available evidence before we could decide what further research needed doing, as no suitable synthesis already existed. We therefore commissioned a broad-based overview and literature review from Cardiff University's School of European Studies, which would bring together existing data on issues of value to the Review and focus on a few key issues.

C.16 Professor John Loughlin of Cardiff University presented the results of this project, summarising findings on approaches to local government finance in other countries. The research showed the following conclusions:

- there were two sources of local revenue – 'own resources' (local) and 'transfers' (from central government). Overall, there was a general trend towards increasing transfers and decreasing own resources, though transfers were increasingly block rather than ring-fenced grants;
- in most cases, local authorities had little influence in determining the size or rate of revenue sources. Some forms of local taxation were effectively assignments of central taxation and involved little or no local autonomy over the rate of tax;
- most countries had a mixture of local revenue sources. Only a few were dependent on a single source, e.g. UK and Ireland (property tax) and Sweden (income tax);
- property tax was the classic local tax, but had been relatively on the decline; however, Italy had introduced a new property tax;
- Scandinavian countries were specialists in local income tax (LIT), but others (e.g. Belgium, Italy, Spain) also had forms of this tax.

C.17 We then commissioned Cardiff University to produce case studies of two relevant countries and their practical experience of different local taxes. The countries chosen were Sweden (which was dependent on LIT) and Spain (which had a variety of local taxes). Both had a more local balance of funding than the UK, and had recently undergone reform to their local government finance systems.

Case studies

C.18 Professor Loughlin reported on the Swedish local government finance system in March 2004. He concluded that:

- Sweden had a distinctive model of government and society, based on consensus, co-operation, and high tax rates and welfare provision. It was much more homogeneous than the UK and, as such, its system (or parts of it) was not necessarily transferable;
- the 'Swedish model' was also felt to encourage strong local government (raising 60% of its own revenue), and uniform standards through equalisation. LIT was very popular, and Sweden's property tax was nationally set and raised;
- local government finance reforms in the 1980s had accepted some inequalities between areas, and had tried to cut the problem of extensive tax avoidance by the rich.

C.19 He reported on the Spanish local government finance system in April 2004. He concluded that:

- both Spain and UK were unitary states moving to an incremental decentralisation of some central tax powers. But they started from different points and Spain had higher taxes. Also, Spain had devolved far more power (to raise taxes and set tax rates) to strong regional governments than to its municipalities;
- Spain's main local tax was on property (domestic and business, including land as well as buildings). There were local elements to income, sales and other taxes. This mixed system could work well, and in practice, most regions adopted similar local tax levels to avoid 'cliff edge' effects;
- having several revenue sources gave local government more flexibility than in the UK (or Sweden). But it could be hard for taxpayers to see links between the tax they paid and public spending, and tax evasion was more likely;
- Spain also had no resource equalisation system similar to that in the UK and its large number of local authorities (8,000 municipalities as well as regions and provinces) made negotiations for funding often difficult and unequal.

C.20 We agreed that the international lessons work and case studies were useful. But it was hard to draw direct lessons from other countries because it was rarely possible to compare like with like. It was not possible to take individual taxes in isolation as they were part of a wider local government finance system (and indeed, a whole political culture).

Annex D
Responses to Public Consultation

D.1 We decided to seek the views of stakeholders on those local government finance issues that were within the remit of the Review. On 16 July 2003 the Chair issued an open letter inviting interested parties to submit short papers. Those invited included all local authorities in England and a number of business and other organisations. The consultation was announced to both Houses of Parliament and to the press on 16 July. The letter was available on the Office of the Deputy Prime Minister (ODPM) website.

D.2 The invitation letter posed a number of questions based on the Review's work so far. Responses that did not answer these specific questions were also welcomed. The consultation also sought views on specific options for change.

D.3 The Review secretariat produced a summary report of responses for us to consider at our October meeting.[1]

Who answered?

D.4 There were 215 responses to the consultation between July and September 2003. These included letters from members of the public to ODPM that were relevant to the Review although it was not always clear whether these were fully aware of the Review's remit or consultation.

D.5 Letters from the public received since October 2003 were noted, but not formally logged as consultation responses. But this report also seeks to take their concerns into account.

D.6 Of the responses, about two-thirds (135) came from local government. These included local government representative organisations as well as individual shire county, district, unitary, metropolitan, London, fire and police authorities. There were high response levels from shire counties and northern cities.

D.7 A further 45 responses came from members of the public, including a number of pensioners concerned about the effect of council tax rises. Most were from rural areas, in particular Norfolk, Devon and Bedfordshire.

D.8 Finally, about 35 responses came from a variety of organisations and individuals, including business organisations, interest groups, think tanks, other relevant organisations, pensioners' groups, academics and other interested individuals.

1 BoF 12: Summary Report of Public Consultation

Responses by local authorities

D.9 All local authorities who responded were members of the Local Government Association (LGA), and at least half explicitly supported the LGA response or provided responses that were broadly similar. The main points were that:

- a successful local government finance system must be based on a range of principles (e.g. accountability, fairness, sufficiency, buoyancy);
- gearing was caused by the balance of funding and was a major problem;
- local election turnout was low for many reasons which might include the current balance of funding;
- ring-fenced and specific grants blurred accountability;
- council tax was not fair to low income groups and was not buoyant;
- local government did not have enough overall income to meet needs;
- local government should have access to more than one tax;
- poor accountability was not conducive to efficiency;
- options the Review should consider included re-localising business rates, local income tax (LIT), council tax reform to make it more progressive, and a range of other smaller sources of income (e.g. local sales tax);
- no change was not an option.

D.10 Although most authorities broadly supported these views, there were significant differences of emphasis over individual issues. For example, some said that gearing was the greatest problem, while others thought it could be a spur to efficiency. Others saw other factors (e.g. ring-fencing of money by central government) as equally or more important. Equally, some councils supported a LIT while others were highly opposed.

D.11 However, no local authority response disputed the argument that there were serious issues of accountability in the current system due to its lack of clarity or that council tax was not working in its current form and at current levels. None disputed the need for equalisation through central grant although many were dissatisfied with how the grant system worked for them. Most argued that they should have a greater variety of sources of income which should be buoyant. Most favoured re-localising the business rate.

Responses by members of the public

D.12 The majority view of those members of the public who responded to the consultation or wrote to the ODPM on this subject was that recent council tax rises were unfair on them as the tax took little account of their fixed incomes. They saw fair taxation as based on ability to pay, though many also considered user charges or sales taxes fair, on the basis that those who use a service should pay for it.

D.13 Many responses from taxpayers showed frustration and cynicism with local and central government, in part due to a perceived inability to determine where responsibility for tax rises lay. The issues of gearing, equalisation and the balance of funding were not normally raised by these responses. Some said that council tax bills should be capped and many had specific complaints about local government inefficiency.

D.14 Many of this group made suggestions as to what should be done. Of these, some favoured reform of council tax to protect pensioners. Others said that it should be abolished and replaced by a tax based on ability to pay. It was not always clear what replacement tax was proposed, though usually it appeared to be a form of LIT, which was either:

- variable – i.e. rates are set by the local council (and perhaps also collected locally); or
- assigned – i.e. central government raises national income tax and gives a fixed amount to local councils, with no power for councils to set rates.

Other responses – business, interest groups, external experts

D.15 Responses by this group were very varied. Some addressed a single issue in great detail (e.g. accountability, the grant system); others proposed re-constructing the whole system from first principles.

D.16 Many felt that transparency and accountability were critical to the system as a whole, as it was hard to tell what their taxes were spent on, in part because of the complexity of the system, although gearing was not directly relevant to this. Some felt that whatever taxes were used must not only be 'fair' (however defined) but also make the system stable, buoyant and easy to administer. Some saw major reforms to the equalisation system as particularly important.

Other issues raised

D.17 Many responses made general points about the system, such as:

- people needed to know what services were available, what taxes they paid and for what, who was responsible, and that services were well managed;
- levels of government blamed each other and members of the public could not find the truth; so the roles of each level must be clarified;
- local elections were a poor measure of accountability because they did not indicate approval of individual complex decisions;
- councils were inefficient and there was no incentive for them to improve. There must be more dialogue with taxpayers;
- the billing system did not allow comparison between service providers.

D.18 Many other issues were raised by consultation responses. The most common included:

- difficulties with the Revenue Support Grant system and its distribution;
- whether the current system of different tiers of councils (shire counties and districts) worked well;

- whether the scope of local government (i.e. the services currently run by local government) was suitable;
- whether the system incentivised efficiency;
- depletion of capital resources.

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